



Commodity Futures Trading Commission

Office of External Affairs
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
202.418.5080

Speech

The Keys to Smart Regulation
CFTC Acting Chairman Walt Lukken
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I'd like to thank John Damgard and the FIA for inviting me to speak and commend them on yet another successful EXPO. There have been several important changes at the CFTC since the last EXPO. We have two new commissioners – Jill Sommers and Bart Chilton. I know I speak for Commissioner Dunn in saying they have been welcome additions to the Commission for their unique experiences and insights.

To say the least, it has been a busy time since taking over as Acting Chairman in July. In those four short months, I testified three times before Congress, the Commission held two public hearings and provided an extensive report to Congress on the regulation of exempt commercial markets, Congress is actively debating the CFTC's reauthorization, the markets have experienced a major credit crunch resulting from the sub-prime crisis, a large FCM imploded, the CFTC and FERC filed their respective cases against Amaranth, and the CFTC and Department of Justice reached a record settlement with BP for manipulating the propane market. Although my wife wishes otherwise, I do not see the pace of things slowing down any time in the near future.

Much of the job of regulating is reacting to such situations as they arise. This is inevitable given the nature of the financial markets and its broad array of participants. But regulators should not be content to just play defense—we must be ready to anticipate trends as our industry and markets evolve.

I was born in Chicago and lived here for several years so I know how big of a sports town it is. Having gone to Indiana University, my game is basketball. Even so, I have always been impressed with NHL Hall of Famer, Wayne Gretzky. One Gretzky quote has struck me for its insightfulness: “A good hockey player plays where the puck is. A great hockey player plays where the puck is going to be.”

Like hockey players, what differentiates average regulators from exceptional regulators is the ability to anticipate and adapt to change—to play where the markets are going, not where the markets have been.

You cannot talk about the direction of our markets without addressing the most significant driver of change--globalization. And I don't think I need to convince any of you that it's happening quickly. No where are the "flattening" forces of globalization more evident than in the financial services sector. This is aptly described in the recent IBM study regarding the long-term trends in our industry. Not surprisingly, this survey found that technology is leveling the information and speed advantages that firms have traditionally enjoyed and as a result, profits are being squeezed. Technology has democratized the markets, bringing enhanced data, speed and market transparency to all end users, lessening the value added by the traditional intermediation model. The IBM study foresees that market participants will increasingly seek profits through either assuming more risk or mitigating the risk of other market users.

As firms take advantage of these new opportunities, the lines of financial businesses are blurring significantly. From a functional vantage, it is difficult to tell the difference between brokers, hedge funds and exchanges as each tries to compete for each other's business. Exchanges have begun to bypass brokers to directly connect large market users—many of them hedge funds. Similarly, brokerage firms want a piece of the risk assumption and mitigation business as many of them now own exchanges, clearing houses and hedge funds in order to compete for this business. The recent sub-prime crisis has exposed this functional convergence as well as the difficulties faced by regulators in properly overseeing the markets.

As these major structural changes occur, how do regulators keep pace? To be honest, keeping pace is optimistic—realistically, regulators are fortunate to keep the industry's taillights in view. While the private sector views globalization as an opportunity, regulators are grudgingly adapting to the modern economy. In another survey by IBM, 95 percent of the financial industry interviewed thought globalization to be a growth opportunity rather than a threat. Of the five percent who felt threatened, nearly all were regulators. Why is this? Because regulators understand that globalization shakes the foundation of their regulatory models.

Regulators no longer live in a "bright-line" jurisdictional world. Determining where an exchange or firm is located is difficult, if not impossible, with subsidiaries, boards of directors, customers, clearinghouses and self-regulators scattered around the globe. To say the least, it is difficult—but I think the key for regulators is not only to work harder, but work smarter. It is this idea of "smart regulation" that will better aid regulators in anticipating trends in this cyber-driven and borderless environment.

What is "smart regulation?" In my view, there are three key components to the "smart regulation" concept. First, it must be outcome-driven; second, it must be risk-based; and third, it must be globally collaborative.

There has been much debate recently on the relative benefits of outcome-based principles versus rules. There is a developing consensus in the U.S. that principles-based regulation is a model worthy of study, noting that the UK markets are flourishing under such an approach. But rather than fly to London, Washington policymakers need only visit the Windy City where the U.S. futures industry has been thriving under principles since the passage of the Commodity Futures Modernization Act (CFMA) in 2000.

A principles-based system requires markets to meet certain public outcomes in conducting their business operations. For example, U.S. futures exchanges must continuously meet 18 core principles in order to uphold their good standing as a regulated contract market—ranging from maintaining adequate financial safeguards to conducting market surveillance. Such an approach has the advantage of being flexible for both regulator and regulated. As technology and market conditions change, exchanges may discover more effective ways to meet a mandated principle in their self-regulatory roles.

It is important to note that a principles approach does not obviate the need for rules. Rather, a principles system is a hybrid of desired public outcomes complimented by specific rules aimed at achieving those ends. Each regulatory authority—depending on the maturity of its markets—will need to find the optimal balance between the flexibility of principles and the legal certainty of rules.

But smart regulation extends beyond the debate over rules versus principles. Not all principles and rules are created equally. Authorities must have a regulatory thermostat to adjust the agency's focus as critical threats to the public rise.

Risk analysis serves as that calibrating tool and is the second key to smart regulation. Risk-based regulation is advantageous because it inherently requires regulators to incorporate cost-benefit judgments into their decision making. This provides greater certainty that both industry and public funds are utilized appropriately. Instead of a one-size-fits-all approach, regulators can assign their staff according to risk, spending more time on firms that pose the greatest threat to the integrity of the marketplace.

Risk factors were certainly the key consideration in the CFMA's tiered regulatory design for exchanges that tailors oversight depending on the nature of the products traded and the sophistication of the market participants. A highly liquid market limited to only institutional investors may require different regulatory considerations than one involving retail participants and products that are more susceptible to manipulation. The CFTC is one of the first exchange regulators to have developed this tiered approach to oversight and I applaud the E.U. and Japan for adopting a similar risk-based structure.

The last point is that smart regulation requires close collaboration and information sharing among regulators. I term it "relationship regulation" as jurisdictions strive to bridge the informational and legal divides that separate them. But like all relationships, they require a lot of work.

No matter the size of the agency, individual regulators do not have the resources to sufficiently monitor the breadth of the global marketplace. We must rely on the expertise of other regulators, both *domestic* and *foreign*, in fulfilling our public mission. This does not mean that agencies should abdicate their interests. Quite the opposite—each must continue to vigorously pursue its public mission. However, in today's global economy, the means to this end must involve close coordination among regulators.

The CFTC has long been an international leader for coordinating its efforts with its foreign counterparts. The CFTC was one of the first to embrace the "mutual recognition" concept for foreign jurisdictions dating back twenty years for foreign brokers and ten years for foreign

exchanges. However, global competition led the Commission to recently revisit its foreign board of trade recognition policy to ensure that it was working appropriately.

Last year, ICE Futures exchange, headquartered in London and regulated by the FSA, began trading a crude oil futures contract in direct competition with New York Mercantile Exchange (NYMEX), utilizing a 1999 CFTC “no action” recognition letter. Listing of the pegged ICE Futures contract caused regulatory concern because the CFTC could not observe the entirety of a trader’s position in both markets, widening the possibility of trading abuses across borders.

Under a less flexible approach, the CFTC might have required ICE Futures to register in the U.S. regardless of its regulatory status in the UK. Such a path would have resulted in duplicative regulation without furthering the aggregate public mission. But the smart regulation philosophy allows for more tailored solutions, enabling the CFTC to determine whether British law is broadly comparable to the principles set out for U.S. exchanges.

Ultimately, the CFTC reached the right decision and affirmed its recognition policy for foreign exchanges with certain minor enhancements. And with over ten years of experience and 19 foreign exchanges recognized, this regime appears to be working well with no major market mishaps or reports of customer abuse.

Even more imperative is the need for collaboration among domestic regulators given the convergence of the financial markets. As the world of securities and futures encroach upon each other, there is much work that the CFTC and SEC can do to coordinate their differing approaches to regulation. Such important matters as hybrid product approval and portfolio margining need to be addressed by our agencies. While admittedly difficult, resolving these problems could bring enormous benefits and efficiencies to the marketplace. I have spoken to SEC Chairman Cox regarding these issues of mutual concern and am committed to working with him over the coming year on these difficult problems.

There has also been much attention recently on the competitiveness of the U.S. financial services sector and whether changes need to occur in their oversight as markets converge. Treasury Secretary Paulson put forth 30 questions open to public comment on the regulation of US financial markets. I am pleased that Treasury recognized in its release the benefits of the CFTC’s principles approach and tiered regulatory structure. Treasury hopes to unveil their findings in the form of a “blueprint” for regulatory structure early in 2008.

I agree with many commentators that the multitude of financial laws need to be rationalized so that regulators are better able to achieve the public and economic goals of this nation. Some have even suggested merging the SEC and CFTC as a structural means for attaining this aim.

While all ideas should be thoughtfully considered, in my view, policymakers should first focus on “How” we regulate rather than “Who” is regulating. No matter the Washington zip code, our agencies have differing public missions and approaches to regulation. Although not as eye grabbing as discussions of merger, reconciling these differences in how we regulate should be the first focus of our attention and will better equip our agencies to collaborate in achieving our respective mandates.

Earlier this month, the Financial Services Roundtable, whose membership includes the 100 largest financial services companies, released a report called, “The Blueprint for U.S. Financial

Competitiveness.” Much to my pleasure, but not to my surprise, the report mentions the CFTC’s principles-based regulatory approach as a beneficial regulatory model that is already working here in the U.S. Quoting from the report, it states: “By moving to a more principles-based regulatory regime, the CFTC is also more compatible globally and better able to work cooperatively with other regulators based on mutual recognition of comparable standards. Its principles have enabled the CFTC to become more of a prudential supervisor, encouraging a more collaborative relationship with regulated entities while reserving its rights as an enforcer in the case of fraud, manipulation, or trade practices abuse, for example.”

In addition to recommending a principles model for regulating, the report suggests that a regulatory advisory board could help ensure that all financial regulators are abiding by one set of sound regulatory principles. This model would enable regulatory agencies to maintain their specific market expertise, their nimbleness in decision making and their tailored public mission while closely coordinating efforts with other regulators to avoid overlap and gaps that currently plague the system.

This “coordinated specialist” model also reflects how some private firms are organizing to be effective in the global financial markets. Today’s successful global corporations are attempting to push greater autonomy to lower levels of the organization where the expertise and local knowledge exists with tight coordination at the top. In IBM’s recent study on global financial markets, executives rated these specialized international firms as more effective in certain global capabilities than multinational, universal firms due to their niche capabilities and speed of decision-making. Certainly such attributes should also be reflected in those regulating these complex and fluid markets.

This brings me back to the wisdom of Wayne Gretzky. Whether you are a smart hockey player or a smart regulator, the ability to anticipate is the key to success. But in a financial crowd, success is measured in numbers. From the passage of the CFMA in 2000 to 2006, volume on the U.S. futures exchanges has grown 328 percent, compared to the 16 percent volume increase on the three major U.S. stock markets over that time. Today, the largest U.S. exchange as valued by shareholders is located in Chicago with CME’s market capitalization over \$33 billion. While recent years have seen U.S. capital markets losing IPO business overseas, U.S. market share on global futures trading volume has grown from 34 percent in 2000 to 43 percent in 2006.

By all measures, the U.S. futures industry has enjoyed enormous success competing on a global scale under this progressive regulatory regime. I appreciate your attention this morning and I hope the CFTC’s experience with smart regulation can be a worthy model for others to consider. Thank you again.