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Speech

"De Principatibus"

Speech of Commissioner Bart Chilton before the Argus Media Summit, Houston, Texas

October 21, 2009

Introduction

Thank you for that kind introduction. It is a pleasure to be with you today. I thank Argus for bringing us all together. There is a lot going on in energy markets and in financial markets. There also is a lot going on in government aimed at affecting markets in a positive way.

Passing financial regulatory reform this year is key to ensuring market and economic integrity. The House Financial Services Committee approved legislation last week addressing financial regulatory reform. The House Agriculture Committee, which passed a bill back in February, is marking-up a revised version of that legislation today. Numerous conversations took place this past week on the Senate side about moving forward expeditiously. While there are myriad critical issues facing Congress and the Administration, I believe that regulatory reform is too important for markets, for traders, consumers and the overall economy. It needs to be done.

Concurrently, the CFTC and other financial regulators need to continue to move forward thoughtfully on issues such as position limits and hedge exemptions.

The Experiment

Before we get too much into the meat of the remarks, I'd like to share a survey. Abbreviated, it consists of five questions that are to be ranked from one to five. If you disagree strongly with the statement, record a 1. If you agree strongly, record a five. If you are neutral, record a three, etc. There are no right or wrong answers, no right or wrong numbers.

1. "Most people are basically good and kind."

2. "Never tell anyone the real reason you did something unless it is useful to do so."

3. “Generally speaking, people won’t work hard unless they are forced to do so.”

4. “One should take action only when sure it is morally right.”

5. “The best way to handle people is to tell them what they want to hear.”[1]

Tally your numbers and remember the total. We will circle around to it again, I promise, and think you will find it interesting.

Renaissance Men

We are fascinated with “Renaissance” men. They were those iconic figures that appeared to be masters of many disciplines. Throughout history, they have sailed to foreign shores, hunted exotic animals and met people of other cultures, learning and teaching along the way. While on their journeys, they might draw a map, or sketch an artist’s rendering of a rare plant, perhaps conduct research on its botanical or medicinal properties. The same individual, who slew a beast in the wild, might write poetry and music and play instruments—with an emphasis on the “s.” They were impressive and inspiring.

Leonardo da Vinci wasn’t just a fantastic painter of the Mona Lisa and “The Last Supper”; he was a scientist, mathematician, inventor, musician and anatomist.

Michelangelo wasn’t just the sculptor of David or the painter of the Sistine Chapel—or as Vince Vaughn says to Jennifer Anniston in that movie **The Break-Up**, the “16th Chapel.” Michelangelo wasn’t just an artist; he was also a poet and an engineer.

Many of them were even public servants. Sam Houston—truly an American “Renaissance Man”—wasn’t only a U.S. Senator, President of the Republic of Texas, lawyer, and Cherokee Indian trading liaison—he also served as governor of two states: Texas and Tennessee.

Thomas Jefferson wasn’t just a Founding Father and later a President; he was an accomplished horticulturist, inventor and architect.

Another Renaissance man was Nicolo di Bernardo dei Machiavelli of Florence. Machiavelli was a public servant for the Florentine government, but he was also a musician, philosopher, playwright and author.

In 1513, he wrote **De Principatibus**—about Principalities. While **The Art of War**, may sound more familiar, it is **De Principatibus** that is more remembered, under the title of **The Prince***,* published several years his death. His namesake term, Machiavellian, is typically used to describe behavior that is crafty, cunning or manipulative and serves one’s own interests. It often refers to how one behaves when engaged in politics, but is

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[1] Christie, R. and Geis, F., “Studies in Machiavellianism*,”* Academic Press, New York, NY, 1970.

accepted increasingly as an appropriate litmus test for human behavior in all situations—as a personality trait if you will.

In **The Prince***,* Machiavelli proffered a different perspective and philosophy from that of previous writers whose focus was on political realism and idealism. Machiavelli tried to describe the actions that one must take to reap the results they wanted—as demonstrated by the story of a prince ruling a government. The prince performed his public duties, but to maintain his power and do good work for the people (the results he wanted), he did certain not-so-nice things that the public, if they had known about it, would have opposed. In sum, the prince thought that the benefits to the people must be achieved via (sometimes amoral) negative actions that the people might not see or understand. He espoused that "the end justified the means."

Machiavelli thought that manipulation was a good thing because it would lead to a better life for citizens.

Let's circle back and look at your numbers from our survey—which is excerpted from the "Mach IV" test of Machiavellian characteristics. The average should be around 12.5. A higher score, 16 for example, classifies you as a High Mach. A lower score, an 8 for example, would make you a Low Mach. The experts say Low Machs tend to be more dependent and trusting. High Machs tend to be charming and independent, but also calculating, prone to manipulate and even exploit.

Machiavelli accepted that self-interest was the ultimate driver and concluded that the best way to achieve one's personal ends required one to be manipulative.

I See Con Men

While Machiavelli's views were arguably extreme and based on the human experience of 16th century Italy, human behavior in the 21st century is not wholly dissimilar. Self-interest is still a prime motivator. As federal regulators, we see the Machiavellians as well as their victims. We see con men, as well as con women.

During fiscal year 2009, the Commission filed 50 enforcement actions; 34 included allegations of fraud involving pooled or managed investments. Many of these frauds involve the use of "boiler rooms" (operations that use high-pressure sales tactics, usually including false or misleading information) and "Ponzi" schemes (in which the fraudsters return "profits" to their customers that in actuality came not from successful trading, but from either existing customers' original investments or money invested by subsequent customers). These figures do not include those that we and other enforcement authorities, like the FBI and the Securities and Exchange Commission (SEC), currently are investigating. At any one time, our investigators are looking at between 750 and 1,000 individuals or entities for violations of the Commodity Exchange Act (CEA).

We have never in the agency's nearly 35-year history experienced such widespread, rampant Ponzimonium as we are seeing right now. It is a global phenomenon, with Ponzi schemes popping up in places you've only heard about on "Survivor"–for example, the South Pacific island Vanuatu (really). We work jointly with regulators

around the world to address the rising tide of market manipulation and fraudulent activities.

Self-Interest

To be sure, Machiavelli's self-interest philosophy is alive and well, on both sides of the law. Not only are there the individual scamsters, but there are large, powerful corporations defined by their motivations and self-interest that are operating fully within the law. The futures markets are replete with "new speculators": index funds, exchange trades funds or ETFs, pension funds and university and other types of endowments that generally take and hold long positions indefinitely. They have a different *modus operandi* in that they are not interested in the underlying physical commodities as most market participants have been over the years. They are interested, as is their right, in their own possible financial gain from long-term price changes.

I'm not suggesting that these new speculators are purposely intending to manipulate in Machiavelli's terms, nor that they are within the strict definition of manipulation under our current law.

To the contrary, they generally appear to be passive—and indeed, indifferent—to market price movements. That is, they are "price insensitive" for the most part, because they typically do not alter their trading strategy based upon what is taking place on a day to day basis. Nonetheless, their very presence may be skewing markets.

Consider the unprecedented volatility we've seen over the last two years in commodity prices—including $147 a barrel oil prices last summer, down to the mid-30's at the end of the year, then up to around $75 now. We've witnessed a 60% increase this year alone, in spite of the lowest demand and highest supplies in a decade.

More than $200 billion came into these markets in the last several years from these new speculators. I believe it matters that some of these large and long passive traders, the "massive passives," hold a significant portion of open interest. I know that traders strategically consider the massive passive rolls. I also know that everyone sees when the massive passives move from the regulated exchanges to OTC-land.

My view is that these new speculators—the massive passives—have had a non-economic impact. That is to say, they have had an impact that is likely divorced from the fundamentals of supply and demand. I am not suggesting that they have driven prices. I think the fundamentals are alive and well in these markets, but the massive passives have had some impact.

Position Limits

We, as government, have never been about saying, "you aren't tall enough to ride this ride," or that a trader can't use the regulated markets. Nevertheless, we are witnessing unprecedented times. What, then, is the appropriate role for government here? Perhaps there should be limits on trading, particularly in the case of the massive passives. We have used position limits in the agricultural complex for years, and, generally, they have worked exceedingly well. We should do the same for the other physical commodity complexes and the CFTC should put into place hard limits in the

aggregate. I think it is very important, though, to set the bar high enough so that we do not chill legitimate business activity and unintentionally create incentives for off shoring and dramatic increases in OTC activity. We need to establish appropriate sideboards for both the hedging and speculating communities. I hope get it right and hit the bulls-eye on the first try. If not, we can and should re-adjust. The goal should remain to do no harm—to preserve the kingdom, as Machiavelli would say.

Hedge Exemptions

Without redefining hedge exemptions, position limits do not make much sense in my mind. We need to ensure that the exemptions that are granted to hedge legitimate business risks—in both cash and physical markets—are tailored and verifiable. The CFTC, not the self-regulatory organizations—SROs—should be granting the exemptions. As for guidance, look at the language in our proposed release: "*limited* risk management exemption." We need to establish clear rules, focus on how we craft the limitations, so that we don't curb acceptable business activity, and allow companies to hedge their business risks.

These efforts—position limits and hedge exemptions—can move forward at the CFTC on a dual track with the efforts in Congress to bring transparency and accountability to the OTC markets. To steal a phrase, we should "just do it."

Manipulation

Unlike Machiavelli, as a CFTC Commissioner, I'm not particularly fond of manipulation. I do not want the stock markets or the futures markets manipulated. I do not think regulators should do anything to inappropriately interfere with well-functioning free and fair operations of efficient and effective markets, and I do not expect anyone else to either. Manipulation is a bad thing in a regulator's world, as it should be for all of us when it comes to markets.

In early September, the CFTC and SEC conducted two days of joint hearings that were historic in that the Commissioners of the two agencies had never met in a public setting before. One key issue was the divergent manipulation standards of the two agencies. The SEC has a lower legal hurdle to jump, and the Federal Trade Commission and the Federal Energy Regulatory Commission have standards similar to the SEC. I would like to adjust our CFTC standard to be more in line with these other agencies, particularly in light of the Administration's call that the CFTC and SEC harmonize our rules and regulations.

From 2001 through the present, we've filed 35 cases including charges of attempted manipulation, manipulation or both. We've imposed close to $460 million in civil monetary penalties. While that makes it sound as if the Commission has successfully prosecuted all of those cases, in reality, in the CFTC's 35-year history we have only successfully prosecuted and won a single case of manipulation in the futures markets. Only one! And that one was just affirmed last week. We have settled numerous attempted manipulation and manipulation cases, so what is the problem?

Proving manipulation under current law is so onerous as to be almost impossible. Under current law, the CFTC is required to prove "specific intent" to create an artificial

price—a price not responsive to the forces of supply and demand. We also have to prove that the alleged violated had sufficient market control to be able to manipulate, and that the conduct actually caused the artificial prices. So you can see it's a very tough standard. Specific intent to manipulate is not always equivalent to intent to deceive—it requires something more, and it's also very difficult to prove the existence of an "artificial price." All in all, it makes for a very difficult legal burden, not to mention that it leaves a lot of wiggle room for mischief that is clearly prohibited by the Act.

A recent federal court case here in Texas exemplifies the need to amend our manipulation standard. In 2007, the CFTC settled the BP manipulation case for an unprecedented amount of $303 million—the largest settlement in the history of the CFTC. The Department of Justice (DOJ) followed that action by bringing a criminal case against four of the participants in the scheme. Last month, the judge in that case had to throw out the manipulation charge against those four, because (although he made it clear he didn't condone their behavior) he said that, in essence, the CFTC manipulation standard simply could not be met. Clearly, the current standard is not working.

Here's another example of why we need the standard changed. There is something called a "private right of action" available to folks who have suffered actual damages by trading contracts at artificial prices resulting from a manipulation. There are class actions under litigation, relating to manipulation of futures and cash prices alike.

This past August, in another decision here in Texas in Federal Court, a class action case was thrown out—for the second time—against Energy Transfer Partners and its subsidiaries. The Plaintiff class-members alleged that Energy Transfer Partners sold massive quantities of fixed-price physical natural gas at the Houston Ship Channel in order to lower gas prices to an artificially low level to benefit their trading positions. These artificially low prices, the Plaintiff's alleged, caused the prices of the NYMEX nat gas futures and options contracts to trade at artificial prices due to pricing relationships. The class argued that Energy Transfer Partners understood that their manipulative activities in the Houston Ship Channel would affect NYMEX natural gas futures prices, and so they were liable for manipulating the futures prices. Twice the Court dismissed the complaint for failure to allege that the Defendants specifically intended to manipulate prices. The Court devoted over two pages of discussion to the specific intent standard, only to conclude that it was not enough that the Plaintiffs alleged that the manipulation of NYMEX futures prices was a direct, proximate, and foreseeable result of Energy Transfer Partners' conduct. Rather, the Plaintiffs were required to allege facts that Defendants specifically intended to manipulate the futures prices. The Plaintiffs appealed in late September. By the way, Energy Transfer Partners paid a $10 million dollar civil monetary penalty to settle the CFTC action against them based on many of the same facts. So, you do the math on that one.

A more reasonable standard would be a general intent standard, like the SEC's 10b-5 rule. The SEC is not required to prove specific intent. They must prove that the defendant at least acted "recklessly." I am not suggesting that the answer is wholesale adoption of the SEC manipulation standard. I have been urging Congress, however, as part of any regulatory reform measure that they approve, to lower our manipulation standard to at least address the wide range of manipulative activities that can affect prices in the markets of today. Senator Maria Cantwell, someone who thankfully is

highly attentive to these markets, has recognized this need and has introduced legislation in this regard.

Do the Crime, Do the Time . . .

Not only is it extremely difficult to win a manipulation prosecution, we have a tough time putting criminals in prison, in general because of our lack of criminal authority. Neither the CFTC nor the SEC, the two principal federal financial regulators responsible for policing the exchange trading markets in the United States, have legal authority to put bad guys away. Both have authority to bring cases in federal court against fraudsters and scam artists, but the only penalties in their regulatory arsenals are civil—monetary fines, for example. The Federal responsibility for putting people behind bars is reserved, currently, for DOJ. The reality, unfortunately, is this: at a time when the public is clamoring for accountability, it has become tougher and tougher to incarcerate felons because of a lack of legal authority—criminal authority—for financial regulators.

If you do the crime, you should do the time, not just pay the civil monetary penalty. A simple fine (which may or may not get paid), or revocation of a registration does not have much of a deterrent effect.

Violations of commodities and securities laws involve highly technical and complicated trading schemes. To prosecute these violations effectively, attorneys and investigators must be experts in the complex functioning of these markets (not to mention navigating the legal standards). SEC and CFTC enforcement personnel are trained specially to handle these matters, unlike DOJ prosecutors who are trained in fraud and financial crimes generally, but who are likely to be unfamiliar with the specific mechanics of futures trading and the intricacies of federal financial laws and regulations. DOJ prosecutors do a great job, but their resources are scarce and they already have their hands full without asking them to take on these incredibly complex financial market cases.

From 2002 through 2008, the CFTC referred over 170 cases to DOJ and other criminal authorities (such as state and local law enforcement bodies), representing 33% of all our investigations during that time. Fully 65 of those cases ended up being criminally prosecuted. That amounts to roughly 38% of all CFTC filed cases during that period. What that means is that almost two-thirds of those criminal referrals were rejected. One might think that the cases that were rejected were dogs—that we weren't sending them quality criminal cases with the possibility of a successful outcome. That, however, is not so. In fact, in 100 percent of those rejected cases, the CFTC moved forward and we reached a favorable outcome for the government. Unfortunately, in the time that it takes DOJ to reject a case—often up to a year—customer funds are all-too-often dissipated, and the CFTC has an even harder time trying to return ill-gotten gains to consumers.

Other financial regulators around the world—in the United Kingdom, Australia, Hong Kong, and Japan, for example—already have such criminal authorities. Unfortunately, we have some challenging jurisdictional issues with both Congressional committees and with the DOJ. Still, I have yet to hear convincing, substantive reasons why it wouldn't make sense, why it wouldn't be a more efficient and effective use of taxpayer dollars, why it wouldn't provide a deterrent to would-be criminals and why it wouldn't protect

consumers better than the current system. In the absence of such reasons, I believe we need to move forward—and quickly—in this area.

So, in addition to a lower intent standard for manipulation, I am hopeful that Congress will provide the CFTC, and perhaps the SEC, with criminal authority.

Hunt Frequently

One of the things Machiavelli wrote is that the prince ought to hunt frequently. Hunt frequently, he said, in order to keep the body fit and to learn the landscape surrounding the kingdom. This, he explained, would allow the prince to best learn how to protect his territory and advance upon similar ones.

Similarly, we need to be looking for what is next: we need to constantly adapt, to look around the corner, to be nimble and quick, and to understand the environment in which we find ourselves. That's why Congress is to be applauded for the multiple hearings held on regulatory reform. That's why it is important that the CFTC hosted a series of hearings on position limits and hedge exemptions. That's why it is significant that we had those two days of hearings with the SEC on how best to harmonize market regulation. It is why, as the Chair of the EEMAC—the Energy and Environmental Markets Advisory Committee—I have held meetings to discuss what we should be doing to prepare for the possibility of carbon markets. I've estimated that those markets could be worth $2 trillion—the largest of any commodity market on the planet. All of this, I expect, will help the Commission and Congress, just as the prince hunted frequently to better be able to rule, to make some needed and sensible changes—ch-ch-ch-ch-changes that put appropriate sideboards on our rules and regulations and prudently amend the Commodity Exchange Act.

In the past, the CFTC was not known as an aggressive regulator. Therefore, the prospect of change is met with fear of overzealous regulation. I understand that. I understand that when there is the possibility that something could affect your business, you need to take it very seriously. I understand that there are strong self-interests at stake, and they will be defended. But whatever we do, we will do our best to get it right. We now have a full Commission and a new, thoughtful and insightful Chairman, and I am confident we will make sensible and sure-footed progress.

Conclusion

One last thing about Machiavelli. It was his belief that a prince truly earns honor by completing great feats. Guarding against excessive speculation that negatively impacts markets, businesses and consumers; bringing light to dark markets, stopping rampant Ponzimonium, pursuing every possible market manipulation and putting people behind bars who deserve to be there—all of these things have a real potential for being great feats. They are certainly honorable goals, even if it means we have to be a little less popular with some folks for a bit. It is all for the greater good, and it is the public we are obliged to honor.

You have a grand panel coming up here in a bit. Among others joining you, Greg Mocek, our former head of our Division of Enforcement, amassed a stellar record during

his time at the CFTC and will, I am sure, be a very interesting panelist. It should be fun and informative.

Thanks again. Have a great conference.