



## **Commodity Futures Trading Commission**

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# **Remarks**

## **“A Photographer’s Eye”**

### **Remarks of Commissioner Bart Chilton Before Michigan Agri-Business Association**

**August 14, 2008**

#### **Introduction**

Good morning. It is a pleasure to be with you. I thank Jim Byrum for inviting me to be with you today. I've known Jim for many years, since the time he served as the Executive Director for the U.S. Department of Agriculture's Farm Service Agency here in Michigan. He was a shining example of a true public servant and I know he is doing a great job for you in his role at the MABA.

When I spoke with Jim about coming to be with you, he told me to speak about whatever I wanted. Given that license, I'd like to ask each of you take a moment and think about those wonderful photographs in the room next door. Robert Cameron's "Above" photographs must be some of the finest art work in the world. The spectacular views above this hotel, New York City, and Hoover Dam all have a special quality that no other photographer I have seen has captured.

For just a moment, I'd like each of you to picture in your mind one of those vast landscape photographs taken by another famous American photographer, Ansel Adams. Maybe you're imagining a lake with Cathedral Peak and the moon in the background, or a thunderstorm approaching in some remote part of the Yosemite National Park.

Both Cameron and Adams started taking photographs at an early age with a Kodak Brownie camera. Both ventured into an art form that, when they started, really didn't exist as a recognized métier in the world of fine arts. That all began to change when people like Alfred Stieglitz began advocating for photography to be appreciated as an art form. Their success ultimately resulted in the acceptance of photography by the art world and the gallery system.

At first, fine art photographers imitated painting styles. This movement was referred to as “pictorialism.” Ansel Adams and others, however, took a much different approach in their form of fine art photography. They advocated for straight photography—photographs in sharp focus that were not manipulated in any way, but representational of exactly what existed in nature.

Anyone who has visited the southwest United States where Adams took many of his famous photographs knows the great beauty of colors in the southwestern landscapes. The sky, the clouds, and the rocks all have these magnificent colors. But Adams took photos in black and white. He was able to capture that beauty. How did he do it? Very simple: he opened and closed the aperture of the camera. A closed aperture meant the photo was completely dark. An open aperture meant that so much light and information entered the camera that it was completely white, no image whatsoever. A simple technique, but it took the master’s touch to fully evoke the beauty and depth of the polychromatic world in a black and white photograph.

Here is my point, and I do have one: the same concepts that Adams, Cameron and others contributed to photography, apply to what we’re trying to accomplish with regard to our regulatory structure of the futures and derivatives markets.

That’s where I’d like to begin a discussion about what’s going on in Washington and what I believe Members of Congress are trying to accomplish with respect to our oversight of markets. In short, they are trying to ensure that the CFTC as the regulator of these important markets bring things into sharp focus to get an accurate picture of what exactly is occurring. They want to ensure that our “regulatory aperture” is set properly, that it is not too open and not too closed, so that we get an absolute accurate picture of what is going on in our critically important markets.

Let me say here that some of the most ardent leaders in this effort are from your state. Your Senior Senator Carl Levin, Chairman John Dingell, and the Congressman from this Congressional District Bart Stupak have spearheaded the effort to ensure that consumers are protected from fraud, abuse and manipulation. I know we all thank them for their leadership, not just on this issue, but for their tireless work on behalf of Michigan and our nation.

If you’ve been listening to the debate in Congress and around the country on oil and gas prices, you’ve probably heard legislators’ reference “dark energy markets,” or loopholes in our regulation, and a need for additional transparency into the activity occurring there. I’d like to focus my discussion on these dark markets and attempt to, like Ansel Adams, bring things into focus and accurately depict what is occurring.

## **Dark Markets/Loopholes**

There are three commonly referred to loopholes: the Enron loophole, the London loophole, and the swaps loophole. We’ll go over each, one at a time, and get rid of a little of the mystique surrounding them. When I’m done, hopefully you’ll start to see the derivatives markets in a new light, with sharper focus, and more clarity.

### **Enron Loophole**

Let's start with what is now commonly referred to as the "Enron Loophole," which was a provision included as part of the 2000 Commodity Futures Modernization Act (CFMA). This provision deregulated part of the futures markets by certain exempting electronic markets from oversight by the CFTC and creating a new category: Exempt Commercial Markets (ECMs).

As many of you have heard, Enron lobbyists, along with former Senator Phil Gramm, successfully negotiated the final compromise that came out of conference creating this new category. That's not to assign blame on Senator Gramm, but merely to demonstrate why folks started calling this loophole the Enron Loophole.

Here is the practical side of the Loophole: Jeffrey Sprecher, an innovator on all counts, started the InterContinental Exchange (ICE Futures U.S. based in Atlanta) with a group of investors, who saw this opening to start a new exchange and not have to worry about all the pesky regulations associated with the regulated markets. ICE Futures U.S. has been very successful, though I think Mr. Sprecher, who serves as CEO would tell you they couldn't have accomplished this level of success if saddled with the same regulatory hurdles that are applied to designated contract markets (DCMs).

CFMA, in this instance, got government out of the way and allowed the dawn of a new era of electronic trading, which has changed our market structure forever. Did Congress overshoot a little and also create an environment where folks like Enron could take advantage of the system? In hindsight, I think so.

And here's why. Rather than an exhaustive conversation on the inner-workings of Enron Corporation, I'll use another example of a company that actually took advantage of a light regulatory touch provided by the CFMA: Amaranth. This example is easier to understand, and in my view better demonstrates, the problem the Enron Loophole created and the consequences that resulted.

In 2006, we alleged that Amaranth attempted to manipulate the natural gas market by trading very large positions on the New York Mercantile Exchange (NYMEX). The CFTC can see activity on a regulated exchange like NYMEX on a minute-by-minute basis. In coordination with CFTC staff, NYMEX realized these levels were very high. NYMEX began addressing the situation by contacting Amaranth and gave instructions about liquidating its natural gas positions.

But here's the rub. Amaranth liquidated its NYMEX positions and bought similar positions on ICE Futures U.S., which by virtue of its classification as an ECM was not something that the CFTC could readily monitor. In reality, no net liquidation really occurred, and what we're told by economists today is that the ramifications were costly to consumers. In fact, economists have reported that consumers in California paid up to 30% more for energy the summer of 2006 because of Amaranth's trading. Smart people disagree on the exact figure, but it is safe to say that consumers were harmed by Amaranth's actions.

These actions by Enron and Amaranth and the consequences were chronicled in a detailed report in 2006 issued by Senator Levin who chairs a Department of Homeland Security Subcommittee. The report also called for a more oversight in this area and urged that the now famous Enron Loophole be closed.

As a regulator, I'm pleased that through the perseverance of several U.S. Senators, the Enron loophole was officially closed with a reasoned and measured legislative response as part of the recently passed Farm Bill.

## **London Loophole**

The second dark market, or loophole, has been commonly referred to as the London Loophole.

To paint a broad picture of the regulatory approach in London, it is fair to say that their system is very similar to ours, with a few important distinctions.

In April of this year, I had the opportunity to travel to London to meet with my counterparts and deliver a speech, also on a topic of my choosing. The title of my speech was "The Ancient Art of Glassmaking," and my objective was to let our friends in London know that I felt strongly in the collaborative efforts international regulators must take to oversee markets in a more transparent fashion.

I raised three specific issues: first, publication of the "Commitment of Traders" (COT) report, which includes data that gives the public a better sense of what is occurring in markets and also serves the CFTC in our surveillance efforts; second, harmonization of our information sharing needs, with a goal of getting as close to real-time as possible; and third, restoration of consumer confidence by strengthening collective enforcement efforts.

In London, the Financial Services Authority (FSA)—the UK regulator for securities, banking, and derivatives—has not seen the need to produce a COT report. Earlier in the year, an FSA official said it was "too costly." Further the FSA had not taken any enforcement action in eight years.

Here's why that is important for U.S. consumers. The price folks are paying for gas is directly influenced by the price of a barrel of oil traded in futures markets. The most notable trading for oil occurs on NYMEX in the West Texas Intermediary (WTI) contract, the world's benchmark contract for oil pricing. However, NYMEX isn't the only exchange trading a WTI contract. ICE Europe in London has an identical contract that settles off the NYMEX price and is arbitrated by traders everyday. In short, the two are interdependent, and the activities of either market can be felt on both sides of the Atlantic. This "look-alike" contract is what folks are referring to when they talk about our second dark market, the "London Loophole." The foreign trading is referred to as "dark," because the U.S. regulators don't have a sufficient statutory or regulatory window into trading activity on the foreign market, even though that trading affects domestic markets.

Without divulging anything confidential, I can tell you that theoretically a trader could have the maximum number of positions in the NYMEX WTI contract and have more than that number on ICE Europe's "look-alike" contract.

That doesn't mean that there is anything illegal going on. It doesn't mean that there have been attempts to manipulate the market. It doesn't even mean that anyone who has held large positions in both markets has manipulated the market. However, up until

a few months ago, we were not receiving the needed information to even see if there might be a problem of one trader holding large positions on both exchanges.

Large trader positions on ICE Europe who are trading the WTI look-alike contract are important information for us to have here in the United States. This is information that I feel is critical due to the increasing global nature of these markets and the fact that our protection of U.S. consumers must now stretch well beyond our own borders, an effort that I'm proud the CFTC is not only undertaking, but leading.

Last week, I was able to deliver welcoming remarks to a group of international regulators that traveled to the U.S. to learn firsthand from our staff experts at the CFTC about our regulatory system. I talked to them about how a trader's computer is, in a sense, a time machine. Traders can wake up in the middle of the night, on the other side of the world, and arbitrage between different markets. And they do. Is that a bad thing? No, but again it is critical that we get the regulatory framework in place to handle this new environment and that means strong coordination with regulators across the globe.

I'm pleased to say that the relationship with our counterparts in U.K. has improved greatly, and that the international conference we hosted last week is an example of our bridge building efforts with other countries like India, Brazil, Japan, and China to name a few.

With this strong coordination comes the confidence that the problems presented by the "Enron Loophole" won't result with the "London Loophole."

While we are undertaking a regulatory fix to get needed information, and are now receiving information from the UK, efforts are also underway in Congress to address the London Loophole in our commodities law. In fact, leaders in both the House and Senate have proposals to make sure we avoid any disasters and protect American consumers. Both the House and Senate have recently debated these measures and garnered bipartisan majority support, though falling short of passage on procedural technicalities.

I'm told that Congressional leaders in the House and Senate are spending August discussing how to overcome procedural hurdles so that the London Loophole and our final loophole can also be closed permanently.

## **Swaps Loophole**

Which leads me to our third and final dark market—the Swaps Loophole.

This loophole deals with transactions performed in excluded "over-the-counter" markets, many of which are called, simply, swaps.

These swaps transactions are mainly conducted by institutional investment banks that broker deals between commercial and non-commercial traders. Swaps dealers are granted hedge exemptions from the CFTC so that they can narrowly tailor deals between sophisticated entities to meet their business needs and manage their business risks. Over-the-counter activity now comprises 2/3rds of the trading volume in the U.S.; regulated exchanges comprising the other 1/3<sup>rd</sup> of futures trading activity.

The issue comes as speculators have increased their participation in the futures markets, primarily through swaps dealers, in an unprecedented fashion. In fact, at least \$250 billion dollars has come into these markets in the last several years and the question that many people are asking is whether or not that influx of capital is having an influence on the prices of oil and other commodities.

I've had the opportunity to discuss this issue with a lot of really smart people and I can tell you that a lot of them disagree.

Personally, I don't see how \$250 billion dollars doesn't have a thumb-on-the-scale effect on prices. That's an astronomical amount of money invested in commodities as an asset class—a new type of investment strategy in the futures markets and different approach applied to commodities trading. But, again, a lot of smart people disagree about the impact.

In total candor, I'll admit that the only thing I feel comfortable telling you is that I simply don't know what impact this new investment is having; which as a regulator makes me nervous. I'll also tell you that I feel strongly that it merits further investigation so we fully understand what, if any, effect it may have on the price consumers are ultimately paying at the pump.

There are several factors affecting gas prices, but this is one area where we certainly must improve our understanding.

My view is that adding transparency in this area and providing the CFTC with the discretion to take action, if warranted, would be a good thing. It would allow us to have a window into what's going on in certain over-the-counter contracts—not to outsource this activity overseas, but take action if needed.

To continue our photography analogy, it is as if our current regulatory oversight gives us the type of view of these markets one would have if taking a picture with one of those fish-eye lenses—you know, the ones that give you a sense of what you're looking at, but all the imagines are somewhat distorted.

Right now, we can sort of see what's going on but we really can't say with 100% certainty. Having sat through a few Congressional hearings lately, I can tell you that that isn't the message Members of Congress want to take home and deliver to their constituencies. So I expect and am hopeful that there will be legislative efforts in both the House and Senate to ultimately address this issue in a reasoned and measured way.

## **Conclusion**

It is an extraordinary honor to serve as a Commissioner at the CFTC at this important time. I'm proud to be part of an independent agency that strives to be non-partisan, commodity blind, and price neutral. In a sense, we take a look at things with a photographer's eye. We attempt to make reasoned, valued and independent decisions to get a true vision of what's occurring in the markets. We want to have our aperture open to just the right setting. But we do not do this alone. We have an extraordinary

staff at the CFTC in addition to seeking the counsel of people outside the Commission on a regular basis.

Jim Byrum and Kendall Keith both know this firsthand through their collective participation on CFTC Advisory Committees. They have both contributed to our careful consideration during turbulent market times and helped us respond accordingly, and I thank them for their service.

Together we will try to do what's right, with the goal of ensuring that these markets remain honest and viable, not just for market participants, but most importantly for consumers.

Hopefully, our end result will be a regulatory environment that continues to facilitate the creativity that has grown these markets to be the extraordinary economic engines they are today, while providing the protections that consumers and taxpayers expect. It won't be a work of art, but I assure that we will work to ensure that our "regulatory aperture" is as near perfect as possible.

Thank you.