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Speech

As Prepared for Delivery
Compliance and Enforcement in Energy Markets-- The CFTC Perspective
Acting CFTC Chairman Walt Lukken
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I'd like to thank Mark Haskell and Bill Hederman of Morgan Lewis for inviting me to speak today at this FERC Compliance summit and for the opportunity to provide the CFTC perspective on energy market regulation. I would also like to recognize and welcome FERC Commissioner Phil Moeller. It's an honor to join him today.

All my adult life I have been a runner and last fall I ran my first marathon here in Washington DC's own Marine Corps Marathon. I finished under my goal of four hours by sticking to a regimented training schedule and maintaining a disciplined yet plotting pace. I am very proud to have completed the 26.2 miles in the top twenty percent of all runners.

Unfortunately, this long distance training in no way prepared me for the sprinter-like pace of being Acting CFTC Chairman. This new role has much more in common with the Hare than the Tortoise. Since assuming this position in July, I have testified five times before Congress, the Commission has held three public hearings and provided an extensive report to Congress on the regulation of exempt commercial markets, Congress has made significant legislative progress on the CFTC's reauthorization, the markets continue to experience a major credit crunch resulting from the sub-prime crisis, the CFTC and FERC filed their respective cases against Amaranth, and the CFTC and Department of Justice reached a record settlement of $303 million with BP for manipulating the propane market. I better not take off my running shoes as this hectic pace is unlikely to slow down any time soon.

Futures markets play a critical role in the U.S. economy. They provide risk management tools that producers, distributors, and commercial users of commodities use to protect themselves from unpredictable price changes. The futures markets also play a price discovery role as participants in related cash and over-the-counter markets look to futures markets to discover prices that accurately reflect information on supply, demand, and other factors. Both functions would be harmed by manipulation of prices.

With the price of oil recently in the vicinity of $100 a barrel and its gravity pulling the entirety of the energy sector higher, the CFTC has been paying particularly close attention to futures trading in energy commodities, given its importance to our nation's consumers, producers, and economy in general. Based on our surveillance efforts to date, we believe that energy futures markets have been largely reflecting the underlying fundamentals of these markets. This is a crucial part of what we do at the CFTC.

The CFTC's primary mission under the Commodity Exchange Act is to ensure that the commodity futures and options markets operate in an open and competitive manner, free of price distortions. The CFTC fulfills this obligation through a comprehensive, multi-faceted program that is designed to identify and mitigate the potential for manipulation and other market abuses, and to ferret out and punish illegal behavior.

CFTC staff closely monitors trading on the exchanges to detect unusual activity or price aberrations that may indicate actual or attempted manipulation. The cornerstone of our market surveillance program is the Large Trader Reporting System, which requires daily reporting of all traders' positions in a particular contract. Through Large Trader Reports, the CFTC becomes aware of concentrated positions that might be used by one or more traders to attempt manipulations.

I pause to reflect on this extraordinary grant of authority vested in the CFTC. I am not aware of any other market regulator that has the level and detail of trade data that we receive daily to oversee the futures markets for manipulation. To put a fine point on it, the CFTC staff not only monitors daily positions of all large traders, but has the ability to analyze the minute-by-minute trades of these market participants, including hedge funds and other speculators, during times when there is a heightened risk of manipulation such as end of day trading periods. With this year's increased budget for technology, the CFTC's analytical tools and insights into the markets will only improve. Our agency is well equipped for the cyber trading age where information is the key and we collect some of the largest, most detailed datasets in the financial services industry.

This data has also been helpful to the CFTC's Office of Chief Economist, which has some of the best economic minds in the derivatives field. This office is critical at providing economic analysis to the Commission as it forms policies affecting this industry. For example, speculators are often the target of criticism and blamed for artificially setting prices in these markets. These suspicions are not new and date back to the time of Mark Twain, who said, "There are two times in a man's life when he should not speculate: when he can't afford it, and when he can."

Despite these suspicions, the proper and efficient functioning of the futures markets requires both speculators and hedgers. Speculators, as a class, provide the market liquidity to allow hedgers to manage various commercial risks. It is clear that speculation is an important component of the futures markets, but there is a point when excessive speculation can be damaging to the markets. As a result, the CFTC not only monitors the markets and its large participants, but also mandates position and accountability limits at certain times to minimize and deter manipulative behavior.

A recent study by the Office of Chief Economist found that speculation as a class is not as influential as some commentators would have you believe. Staff studied the relationship between futures prices and hedge fund positions in the crude oil and natural gas markets. The study found that when new information comes to the markets, it is the commercial traders, such as oil companies, utilities and airlines, who react first. They use the futures markets to hedge their price risk and need someone to take the other side—this is where the large speculators play a role. The hedgers require liquidity for risk management and the speculators provide that liquidity for a price. The study also found that, on average, large speculators do not change their positions as frequently as other market participants, primarily hedgers. While speculators continue to play an integral role in the futures markets, the report concludes that speculative buying, as a whole, does not appear to drive up prices.

Certainly, the landscape of the energy trading sector has changed dramatically in recent years. While these speculators have grown in numbers, so have commercial traders as the pie keeps getting larger. Not long ago, NYMEX was the only sizeable energy exchange around. Now it has a strong competitor in the Intercontinental Exchange or ICE, which has taken a significant slice of the natural gas and crude oil trading business at its respective exempt marketplace in Atlanta and regulated exchange in London.

With these significant industry realignments, how has the CFTC and its regulations kept pace? It has been difficult, but I firmly believe that the sign of a good regulator is one that can adapt to change. The Great One—NHL's Wayne Gretzky—once quipped, "A good hockey player plays where the puck is. A great hockey player plays where the puck is going to be." Similarly, regulators must be ready to anticipate and adapt to trends as our markets shift. The CFTC is well poised to tackle evolving markets thanks, in part, to its principles-based regulatory regime.

It was the adoption of principles-based regulation with the passage of the Commodity Futures Modernization Act (CFMA) in 2000 that has allowed the CFTC to work smarter. The 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—ranging from maintaining adequate financial safeguards to conducting market surveillance—in order to uphold their good standing as a regulated contract market. 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 fact, the CFTC has the distinction of being the only U.S. federal regulator that employs a principles-based approach. Many U.S. policy makers are considering ways to enhance U.S. financial sector competitiveness by rethinking our regulatory structure. This year, U.S. Treasury Secretary Hank Paulson is expected to release a "blueprint" for a modernized regulatory structure. In its request for public comment, Treasury recognized the benefits of the CFTC's principles approach and tiered regulatory structure. In 2007, the Financial Services Roundtable released a report called, "The Blueprint for U.S. Financial Competitiveness." This report also mentions the CFTC's principles-based regulatory approach as a beneficial regulatory model that is already working here in the U.S. Debate on the benefits of outcome-based principles will continue and the CFTC remains ready to share our experience with a principles-based approach as a worthy model for consideration as this debate evolves.

Thankfully, with the passage of the CFMA and the implementation of a principles-based regime, Congress had the foresight to provide this agency with the flexible tools needed to oversee this rapidly changing marketplace. The CFMA created a tiered regulatory structure for the futures industry, which tailored requirements to the specific risks of the marketplace. Within the tiered design, Congress created a light-touch regulatory category called Exempt Commercial Markets or ECMs, on which certain commodities, such as energy products, could be traded by institutional participants. As I mentioned earlier, ICE is the most prominent of these new exempt exchanges.

Over time, as this new trading venue grew and became more linked and correlated to CFTC regulated products, it became clear that certain exempt products on ICE may have outgrown their statutory design and changes were necessary to protect the public. Remember Wayne Gretzky—good regulators must play the markets for where they are going, not where they have been. Based on this sector's growth in size, structure, and importance, the Commission felt compelled to act.

Within three months of my taking office, the Commission convened a hearing last September to examine the oversight of trading on ECMs. Commission staff, exchanges, ECMs, and industry and consumer groups testified before the Commission in a productive debate. Testimony from the Commission's hearing on this subject led us to conclude that certain natural gas products on the InterContinental Exchange (ICE) and New York Mercantile Exchange (NYMEX) function as virtual substitutes. Not only are the products substantially identical in terms and pricing, but the market participants are also the same with all of the top 25 natural gas traders on NYMEX also trading significantly on ICE. Moreover, economic analysis by our staff indicates that the trading activity in these products on ICE serves a significant price discovery function on 20 percent of the trading days measured.

Based on this hearing, the Commission unanimously presented a report last fall to its authorizing committees in Congress detailing its findings and recommendations regarding these energy markets. As we sought the proper solution, I was reminded of Ronald Reagan's warning, "The nine most dangerous words in the English language are 'I'm from the government and I'm here to help'." In other words, too much "help" from the CFTC had the potential to destroy the markets we were trying to protect.

I believe the CFTC's recommendations struck the right balance of increasing regulatory oversight where appropriate, while maintaining the economic opportunity and increased competition and innovation that ECMs have brought to the marketplace.

The Commission in its report recommended that our Act be amended so that when an ECM futures contract is determined to serve a significant price discovery function, the Commission would have the authority to: 1) Require large trader position reporting for that contract, 2) Require an ECM to adopt position limits or accountability levels for that contract, 3) Require an ECM to exercise self-regulatory responsibility over that contract in preventing manipulation, and 4) Exercise emergency authority regarding such transactions.

These recommendations, endorsed by the President's Working Group, have been well received on Capitol Hill. In December of 2007, CFTC legislation moved forward in both the U.S. House of Representatives and the U.S. Senate. The Senate added a CFTC reauthorization amendment to the Farm Bill and the House Agriculture Committee approved a similar bill. While they do have differences, both bills largely adopt the CFTC's recommendations on the need for enhanced oversight over certain energy contracts. These bills also reauthorize the agency through 2013 and include increased manipulation penalties similar to FERC levels and enhanced authorities over retail foreign currency fraud. Congress is back in session at the end of the month and we're hopeful that the process to negotiate a compromise bill as part of the Farm bill will move forward quickly.

Turning back to a principles-based regulatory approach, some of you must wonder how enforcement fits into the larger picture. It is true that using a principles-based approach to regulation encourages a more collaborative relationship with the regulated entity but when improper activity occurs, this collaboration on the front-end must be complemented with strong enforcement on the backside. This "bookends philosophy" is a powerful approach in preventing and deterring wrongful activity in the industry. I call it "prudential regulation with a bite" and we need to look no further than the CFTC's enforcement program to see that a principles-based regulator can make an impact in stamping out fraud and manipulation.

During the last five years, the Commission filed 39 enforcement actions, charging 64 companies and individuals with attempted manipulation, manipulation and/or false reporting. To date these actions have resulted in civil monetary penalties of more than $434 million. And these defendants are some of the big players in the industry—BP, Enron, Reliant, El Paso and others. The CFTC maintains a zero tolerance policy toward anyone who attempts to manipulate or disrupt the pricing in these important markets.

I want to highlight the recent enforcement case against BP that resulted in the largest manipulation settlement in our Commission's history. The investigation, jointly brought with the Department of Justice, uncovered that BP manipulated the propane market used for residential and commercial heating in the Northeastern United States in February 2004 and attempted to manipulate that market in April of 2003. The investigation revealed that BP employees claimed to "control the market at will," allowing BP to dictate prices to other market participants in order to obtain a significant trading profit.

In settling the Commission's charges, BP agreed to pay $125 million in civil monetary penalties and $53 million into a restitution fund intended to return money back to victims. The settlement was one of this agency's most comprehensive and was designed to not only punish past behavior at BP but to ensure that market misconduct does not happen again. As part of the agreement, BP agreed to establish a significant compliance and ethics program and to install an independent monitor to oversee BP's trading activities. There were also criminal aspects to the case, which BP settled with the DOJ by paying $100 million in criminal fines and $25 million into consumer fraud fund. The total monetary sanction to BP as a result of its massive fraud was $303 million.

Another high profile enforcement case we continue to work on is Amaranth – and many of you are aware that the CFTC and FERC both have enforcement proceedings against the company over its conduct on NYMEX. The CFTC and FERC stand shoulder to shoulder in the goal of ensuring that the energy markets remain free from manipulation. However, the question of agency jurisdiction has been raised and is now being considered in the courts. Both Chairman Kelliher and I have respectfully acknowledged that the agencies have a difference of legal opinion on the CFTC's exclusive jurisdiction that will likely be resolved by the courts.

Despite these differences, we both recognize the growing need for our agencies to cooperate in overseeing these markets within the bounds of our legal authority. As called for by the Energy Policy Act of 2005, the CFTC and FERC entered into a Memorandum of Understanding (MOU) in October 2005 to coordinate information sharing without the need for cumbersome access requests for each particular matter. Our Commission staff remains in regular contact with counterparts at FERC, and FERC staff is routinely invited to attend CFTC enforcement and surveillance meetings to share information on issues and matters of mutual interest. This cooperation reflects the largely positive relationship shared by the agencies during the last two years.

It is also important to note that I have great respect for the FERC and its capable staff and I support the grant of enforcement authority provided to FERC in the EPAct of 2005 to prevent manipulation of the physical energy markets. The entirety of the California energy crisis involved the manipulation of physical power generation and there certainly remains an enforcement need beyond the CFTC's authority to police this type of wrongful activity in the physical power space.

But as the MOU recognizes, the futures markets fall under the exclusive jurisdiction of the CFTC. And it's based on important policy reasons. At the time of its enactment in 1974, lawmakers understood that these markets could not function without this extraordinary grant of exclusive jurisdiction since all futures contracts have an underlying cash regulator—whether it is the SEC for equity futures, the Treasury Department for interest rate and currency futures, or USDA for agriculture futures. The involvement of multiple regulators with multiple legal standards could make these markets unworkable. Over time, these various regulatory interests recognized the CFTC's principle role in the oversight of the futures markets and as a result, a relatively seamless and collaborative system of oversight and enforcement has developed between the cash and derivatives markets in these products. I am committed to finding a similar balance with FERC regarding energy matters to ensure that manipulation does not go unpunished no matter where it occurs.

Already, our staffs have met to discuss the current MOU and any efforts that might be considered to further coordinate our efforts. Chairman Kelliher and I continue to discuss ways to improve communication between Commissions to enhance collaboration and ideas to educate users of the markets on best practices for benchmarking against these exchange products. I look forward to continuing to work with FERC on this and other matters that involve the proper oversight of the energy markets.

I will conclude my remarks by stating the obvious – that I don't plan to hang up my running shoes anytime in the near future in order to keep pace with the energy industry. Although all U.S. markets, including energy, have been volatile in recent months, it is precisely during such volatile times when the risk-management and price-discovery features of futures markets are needed most. The staff of the Commission continues to conduct very close surveillance of these markets to ensure that they remain functioning properly. Improper conduct will not be tolerated, and the CFTC will continue to pursue aggressive enforcement actions against those who break the rules.

With such high energy prices, it is not surprising that some have found fault with the futures markets. But blaming the futures markets for high commodity prices is like blaming a thermometer for it being hot outside. The CFTC's role is to ensure that no one is holding a match under the thermometer. In my view, we are doing an effective job.

Again, thank you for inviting me speak today and I'll be glad to answer any questions you may have.