



Commodity Futures Trading Commission

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Speech

CFTC's "American Idols": Reality Regulation

**Speech of Bart Chilton, Commissioner
United States Commodity Futures Trading Commission**

before the

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Thank you for the opportunity to be with you today. It is great to have an opportunity to be here with you to talk about some of the exciting, hands-on, real-time efforts going on at the CFTC as the oversight regulator of your dynamic industry. We're working hard to ensure that these markets are safe and effective vehicles for price discovery and risk management, and at the same time promote the incredible innovation and competition that are the hallmarks of the futures industry.

"Reality" Regulation

Let's start out today with something you're probably not expecting: reality TV shows. Although I'm no Ryan Seacrest (at least, I hope not), let's discuss some of the reasons for the incredible popularity of this relatively recent trend. This may surprise you, there are currently **over 300** reality television shows that air weekly, and there is a website devoted to solely to covering reality television—"Reality TV World"—which promotes itself as "the Internet's leading resource for reality televisions news and information." (Incredible, but true.) Then we're going to think about how the CFTC regulatory efforts fit into "reality phenomenon" mold. (I know, sounds strange, but bear with me—you get to vote at the end.)

First of all—admit it—each one of us, at one time or another has watched a reality TV show. Some of us are proud of it, unabashedly rescheduling our parents' anniversary celebration so as

not to miss an episode of “Survivor”; others of us are “closet reality watchers,” secretly checking out the “Girls Next Door,” or TIVO-ing “Cops.” You hear it everywhere—at the grocery, at the gas station, at the dentist’s office—discussions of Sanjaya and Richard Hatch (you know what I’m talking about—don’t pretend you don’t), and who’s going to get canned on the next Trump-dump. But here’s the interesting question: Why do we watch? Why do we care?

Interestingly enough, there’s been a great deal of research on this (there have been articles written on this topic in the “Journal of Consumer Research,” and the “Australian Humanities Review,” for example), and people who have looked into it have found that one of the overwhelming reasons for the great interest in these shows is that viewers want to **feel like they are a part of what they are watching**. They want to be a participant, if you will, not just a spectator. They want to be connected, to feel some ownership in the process, to be part of the action, not just looking at it through the window.

Now here’s where I make the parallel to regulation: you—as taxpayers, as consumers, and as American citizens—need and deserve to be a part of the regulatory process. After all, it’s **your** government, it’s **your** money paying for it, and it’s **your** interests that are to be protected by governmental functions. The noted writer John Renesch said, “Democracy is a team sport. It is not like going to a ballgame where you sit passively and decide if you like the players and evaluate their abilities after watching the game. We are the players, we are the team, in a democratic nation or a democratic world.” Unfortunately, all too many of us don’t take advantage of the opportunity to participate—in the last presidential election, while there were approximately 221,000,000 people eligible to vote in the United States, but only about 122,000,000 exercised that right, or about 55%. For whatever reason, it seems like people do not feel connected or a part of their own government. So it’s no wonder that people feel disgruntled or even angry when they feel like their government isn’t doing what it’s supposed to do, or even worse, when they have no idea what their government is doing for them.

And sometimes it seems like we don’t encourage participation enough – or at least we don’t always make it easy. But, we have a regulatory success story to tell the CFTC. We’re the only federal agency in the US with something called “principles-based” regulation, and it’s become the gold standard for how to regulate in a smart, effective fashion. Regulators not only around the country, but around the world, look to our agency as an example of how to govern efficiently and responsibly. And the benefits of principles-based regulation are self-evident: it has allowed the US futures industry to grow and prosper in the most dynamic, innovative, and competitive manner possible. Just look at the number of new trading platforms and novel innovative products that have arisen since enactment of the CFMA in 2000—if anyone asks whether principles-based regulation is good for business, there’s the answer.

And it’s good for the regulator as well. We’re able to target our scarce resources where they are needed: ensuring the markets are free from fraud and manipulation, and protecting the interests of the American public in the marketplace.

So in that vein, I’d like to take a few minutes today and tell you about some “CFTC American Idols,” some real-life, real-time people who are working hard every day on the job for **you**, protecting the interests of the American consumer. Let’s look into what they are doing year-in and year-out, watching out for your interests. (And don’t forget, you get to vote at the end.)

First, let's take a look at something that hit close to home here in Miami. In February 2006, CFTC Trial Attorney Linda Peng, working out of our New York office, filed a Commission case in federal district court alleging that Lazaro Jose Rodriguez, a Cuban-American living in Miami, stole approximately \$2 million from more than 400 people who opened accounts with his firm to trade commodity futures and options. Ms. Peng, working with a team of other CFTC attorneys and investigators, uncovered an "affinity fraud" scheme cooked up by Rodriguez. It's called "affinity fraud," because in this type of scheme, the bad guys go after people with whom they have a common bond. In this case, Rodriguez targeted Latino-Americans and Haitian-Americans, folks he bilked out of \$1,000, \$2,000, or \$5,000 at a time. He made false promises to these unsuspecting investors, guaranteeing them large profits and little or no risk. He also fabricated account statements, making up figures to lull investors into a false sense of security that they were actually making money. He even had the audacity to go to some Miami high schools, offer to help out as a "teachers' aid," and once he had the teachers' trust, he bilked them out of their savings as well. Rodriguez used investors' their money to buy two Corvettes (each worth over \$80,000 apiece), jewelry, and other personal items for himself. We found out about this case when the wife of a defrauded customer called the CFTC to say that her husband had lost \$1,000 with this guy (and these poor folks couldn't afford to lose \$1,000). We started an investigation, and pretty soon we found that Rodriguez had stopped paying his employees—not a good thing when you're a crook—and they were not at all unhappy to "sing" to the government to assist in our prosecution. This chain of events ultimately led a decision in December of 2007, when the federal court announced a judgment against Rodriguez, and ordered him to pay a significant penalty. Notably, Ms. Peng and the CFTC team also worked with the FBI (who did undercover work to help in the investigation of Rodriguez), the U.S. Attorneys' Office for the Southern District of Florida, and the Florida Office of Financial Regulation in a cooperative civil and criminal investigation of Rodriguez. That's a pretty good example of your tax dollars working well for you—Ms. Peng prosecuted a guy who bilked working-class Latinos to buy himself fancy cars, and now he's incarcerated in the Taft Correctional Institution in California, ordered to pay back \$2 million in restitution to customers, ordered to pay a fine of \$260,000, and is permanently banned him from the commodity futures business.

Here's another example. In February 2005, CFTC Senior Trial Attorney Karin Roth filed a case on behalf of the Commission in federal district court against a group of defendants in the "Richmond Global" case. In that case, Attorney Roth and the CFTC team uncovered a massive forex fraud scheme that had been ongoing since 2001. The defendants set up a bucket shop in some dingy rooms in a strip mall on Staten Island—all they needed was a few steel case desks and a some phone lines—and from that small set-up they duped over 160 unsuspecting consumers out of about \$2 million. These four guys, employed a couple dozen other fraudsters, cold-called investors from all over the country, as long as they weren't from New York: couldn't risk having anyone actually show up and see their sleazeball operation. Bilking customers out of relatively small amounts of money at a time, the defendants made huge profits for themselves, eventually even purchasing a house on Staten Island with the ill-gotten gains. Commission attorneys and investigators worked with criminal authorities on this case, and found that the defendants made false promises of high returns, didn't disclose hidden commission charges, and actually made up false account statements. After litigation, the court in December 2007 issued a judgment against the defendants, finding that they had defrauded customers out of \$1.7 million in trading forex contracts, and ordering them to pay sanctions double that amount—\$3.4 million, which included full restitution to defrauded customers in additional civil sanctions. Karin Roth and the CFTC team gave you bang for the buck on this one—not only did the bad guys get punished, but the defrauded customers got a federal court order to get their money

back. Oh, and by the way, three of the four individual defendants are “involuntary guests of the government” right now in federal penitentiaries in Pennsylvania, and will be for the foreseeable future—the fourth one just got out after serving his time. Karin and the other attorneys and investigators, working cooperatively with the FBI and the US Attorney’s Office, did a great service to the American public in the successful prosecution of this case. (And, by the way, that house on Staten Island? Sold, and the proceeds went to pay back customers—now that’s a satisfying ending.)

Another example of a “CFTC American Idol”: Jennifer Diamond, a trial attorney in our Chicago office. On July 12, 2005, Jennifer filed an injunctive action in federal district court in California on behalf of the Commission, alleging that Brett Lovett had defrauded customers and asked the court to freeze his assets. The story behind Mr. Lovett’s scheme is heartbreaking: he targeted members of his Jehovah’s Witness church in a little suburb north of LA, told them he was a “financial advisor and fund manager” (with absolutely nothing to back up those claims), that their money would be safe with him, and asked them to let him trade futures for them. We were tipped off about Lovett’s activities after he had defrauded a young man, a former church member, who lost the family’s inheritance money in this scam. The young man was a sales clerk at Circuit City, lived at home taking care of his sick mother, and was making ends meet on the proceeds of a \$250,000 family inheritance. Lovett found out about the money, targeted him, told the trusting young man that he could guarantee him a monthly income of \$1,200 without touching his principal, and assured him that his money would be safe. You can guess what happened: the money was lost in trading, and what was left went into checking accounts and money market funds in the name of Brett Lovett. Lovett scammed other individuals in the same manner, doctoring account statements to falsely indicate trading profits, and luring people to place their money with him with fraudulent promised of profits at no risk. Ms. Diamond and the CFTC team were successful in getting an immediate asset freeze, and ultimately successful in the case; in November 2007, the court issued an order against Lovett, finding that Lovett committed fraud, and ordering him to pay \$315,943 in restitution to customers and \$320,000 in civil penalties. In addition, Lovett was permanently kicked out of the commodities business. The Chicago team certainly deserves kudos for prosecuting this bad actor, and for ensuring restitution was ordered to his unfortunate customers.

One last example. In February 2005, CFTC Enforcement Associate Director Paul Hayeck filed for the Commission a case in federal district court a case against a group of six individuals working for Shell Trading Gas and Power and Coral Energy Resources in Texas. Paul and his CFTC team alleged that the defendants knowingly delivered dozens of false and inaccurate natural gas price reports to price reporting companies (such as Platts) in an attempt to manipulate the price of natural gas. Coral settled charges against the company in July 2004 for a civil penalty of \$30 million and a cease and desist order.

I mean, get this: these guys just made up numbers and made up trades, and reported them as real in order to move the natural gas market up or down. Paul and his team used emails, IMs, lots of high-tech data in the investigation of this case. Here’s an example: I’d like for you to listen to one of the remarkable conversations Paul’s team got on tape, actually catching these guys in the act of planning to falsely report prices. [play recording of Dizona/Taylor conversation] This wasn’t an easy investigation in many ways—not only did the traders and the energy company not cooperate, the reporting companies were uncooperative as well. This case was filed in conjunction with multiple actions against a total of 15 energy traders, charging all of them with false reporting and attempted manipulation; these cases involved companies, in addition to Shell

and Coral, such as Enserco, Mirant, Cinergy, Duke Energy, and Concord Energy. In November 2007, a consent judgment was entered against five of the defendants in Paul's case, ordering them to pay a \$1 million penalty and barring them from registering in the industry, participating in any capacity requirement registration, or acting as a principal of a registrant. The final defendant, Mr. Dizona, was just found liable for eight acts of attempted manipulation last month after a jury trial in Houston. Again, Mr. Hayeck and his team of CFTC attorneys and investigators gave you, the American consumer, value for your tax dollar—the unscrupulous defendants not only had to write a big penalty check to the government, but they got permanently banned from the business.

I should note, these cases are just the tip of the iceberg. Every day, since these are really 24-7 worldwide trading markets now, we are mining the internet, e-mails and instant messages in an effort to gather critical evidence in very high tech, complicated cases – both domestically and internationally. In fact, while I've mentioned only four cases today, at any one time, the CFTC has between **750 and 1000** individuals or companies under investigation and prosecution. That's more than two for every CFTC employee. So, while you have probably heard about Lake Shore and BP and Amaranth, there are a whole slew of impressive cases that you might not know about. Since these are **your** cases, I thought I'd spend some time focusing on the ones that perhaps don't get so much attention, but deserve it nonetheless.

And while we've been focusing on enforcement cases, there are “CFTC American Idols” throughout the Commission—the Market Oversight attorney who uncovers a too-low fine levied by an exchange and works to address it, the economist who provides analysis data to support an energy market manipulation case, the financial surveillance specialist to analyze possible illegal trading in the T-bond market, or Charlie Ricci, the futures trading investigator who has been with the CFTC for over 30 years, and who now handles all consumer-related calls in our Division of Enforcement, as of last count, over 6,500 of them—not to mention all the folks who provide the support to make the Commission itself run, hundreds of people working on your behalf to protect these markets and market participants real-time, every day, and they do it on a shoestring.

So I guess I won't make you vote, because it would be impossible to choose just one person. I wanted to give you today a snapshot, a little “slice of life” of what the CFTC does on an ongoing basis. This is our “reality regulation,” every day, all day. We're working to make markets safe and secure for risk management and price discovery, to protect the financial integrity of clearinghouses and intermediaries that handle customer money, and to look after the **your** interests, the interests of the American market user and consumer. **And you are a part of it.** We respond to your comments, your questions, your complaints, and your needs, because that's what we're here for. You may not always like the answer, but not because we didn't do our jobs.

There will always be competing interests, constituencies, agendas—that's the nature of any decision-making process. The challenge for the CFTC—for everyone in government—is to consider the common weal as the highest good, and aim for that. The examples I've given you today—CFTC's “reality regulation”—are prime illustrations of the agency's acting for the public good, for **your** best interests. And we'll keep on doing it, even in the face of some significant legal and legislative obstacles.

CFTC Reauthorization

Which brings me to another topic I'd like to address today: CFTC reauthorization. Most of you know the CFTC's last reauthorization ran out September 30, 2005, and we've been operating on continuing budget resolutions since that time—not an optimal way to run a federal agency. There are three primary issues that would be addressed in this reauthorization package: a fraud statutory “fix,” a forex “fix,” and an exempt commercial energy markets “fix.” Let me just say a few words briefly about each of these.

The first legislative “fix” I want to mention that I hope will be included in our reauthorization package has to do with the CEA's primary fraud provision, Section 4b. As many of you know, that was drafted when the futures markets were solely intermediated, and after the CFMA's introduction of non-intermediated markets (like forex and exempt energy markets), there is a clear need to amend the provision to clarify that it applies to these types of transactions as well.

One area of particular concern to me is the rampant retail forex bucket shop fraud that has proliferated in the United States in the past few years. The CFTC continues to be extremely aggressive in prosecuting cases in this area, and the Richmond Global case I spoke about is just one example. But we did have a setback that we received from Judge Easterbrook in the Zelener case, and more recently from the Sixth Circuit in the Erskine and Goros case. Zelener was the archetype of what we see in this area: this guy set up shot targeting unsuspecting folks with good hearts and limited incomes; over 200 customers lost more than \$4 million dollars in this fraud scam. Zelener and his cronies essentially guaranteed their victims a profit, and then took their money. It's doubtful whether Zelener actually invested in foreign currencies or anything else. Meanwhile he shipped their money offshore.

Our Division of Enforcement, in 48 hours, tracked the money through three countries and into 38 bank accounts. We caught them, and we prosecuted them. The 7th Circuit's opinion finding that these contracts were not futures was a real blow to us, but we continue to aggressively litigate around the country, and we're not taking this lying down. We also work with NFA in actively going after these bad actors.

The problem is, other courts are following Zelener (such as the Sixth Circuit did last month in Erskine and Goros), and we really need a legislative fix to address this.

One issue is whether the fix just takes care of forex or if the language is broader and ensures that IF this type of fraud is used in the future in other areas – metals or agriculture for example, that the CFTC has the enforcement tools we need. I'm hopeful that Congress will be able to act promptly to ensure that the CFTC will be able to prosecute Zelener-like bucket shop contracts, wherever they may be offered to unsuspecting investors.

Another significant problem facing the CFTC has to do with “exempt commercial energy markets.” There is a provision in the CEA for these markets, and it's sometimes called the Enron Loophole. Frankly, I think this provision was the only real flaw in the CFMA. It was inserted, literally, at the eleventh hour at the behest of Enron's attorneys. There was never a hearing or any open, public discussions on this provision. The good thing it did was increase competition; for example, it helped foster the incredible growth of the InterContinental Exchange (ICE). But the provision has resulted in some significant unintended consequences that need to be addressed now.

It is very difficult for the CFTC to achieve our mandate when we have look-alike energy markets operating “in the dark,” that are not subject to the same rules and regulations as other risk management markets. The good government approach to this is not to wait for another economic calamity to occur. We have seen what can happen with Enron and BP and Amaranth, and while the CFTC has been aggressive in prosecuting those matters, this really needs a Congressional remedy. So for me the question isn’t “if” but “how” and when something should be done to address the Enron Loophole, and I think the sooner the better.

Again, I hope that Congress can act promptly to address these issues.

Conclusion

As you can see, the CFTC is doing a lot, on a very tight budget. The President’s budget for the agency went to Congress earlier this week, and I’m hopeful that Congress will be able to act promptly on that appropriation. A couple of final thoughts on our budget: if you compare the CFTC to other agencies in the federal government, it’s pretty clear that you’re getting your tax dollars’ worth with us. Just think of these numbers: over the past five years, we’ve assessed over \$500,000,000 in penalties. Since our annual budget is roughly \$100,000,000, you could make the argument that collection of those penalties alone would fund operation of the agency. We operate with a staff of 435 people, roughly 12% the size of the SEC, yet we oversee markets with market capitalization that dwarfs the size of the largest U.S. stock exchanges. The SEC, on the other hand, has approximate 3,700 employees. So while the CFTC is relatively small, you can see that it is clearly an efficient and effective steward of the responsibilities entrusted to it by Congress to protect your interests.

Let me conclude by saying how privileged I feel to be a part of this dynamic industry. Everyone at the CFTC will continue to work hard every day to ensure that we do all we can to protect price discovery, to guard against fraud, abuse and manipulation, and to ensure that the futures and options markets remain viable efficient and effective tools not only for hedgers and speculators, but also for consumers. We know how important it is to your industry and it is important to our country. Thank you.