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Speech

Changing Market Behavior through Acceptable Practices
CFTC Acting Chairman Walt Lukken
ABA Committee on the Regulation of Futures and Derivative Instruments
Winter Meeting
Puerto Rico
February 1, 2008

I would like to thank the ABA, Paul Pantano, Charlie Mills and the other members of the committee for inviting me to speak to you today. It is always nice to be back with all of you in Puerto Rico.

While we conference here in San Juan, tomorrow thousands of people will gather on Gobbler's Knob in Pennsylvania to await the appearance of Punxsutawney Phil on Groundhog Day. This annual predictor of winter's length was memorialized in the movie Groundhog Day. You remember this movie – where the weatherman, played by Bill Murray, finds himself in a time loop stuck repeating the same day over and over again.

I have to admit--I sometimes feel like Bill Murray living the same day over and over. After all, we have the same lawyers debating the same issues in the CFTC's reauthorization; policymakers are still arguing over the impact of the Zelener case on the CFTC's fraud authority; Greg Mocek and his enforcement team still have their crosshairs on manipulation in the energy sector; exclusive jurisdiction is again at issue; and there is an ongoing debate on whether to merge the CFTC and SEC. Some days feel like we are stuck in a time warp or as Yogi Berra artfully said, "It's déjà vu all over again."

It has been incredibly busy to say the least. And I am just talking about the last week. Even since these remarks were first prepared, the markets have experienced a $7 billion trading fraud, the possible merger of CME-NYMEX was announced and the Fed cut 1.25 percentage points off the fed funds rate. This has been the hectic pace since taking over as Acting Chairman in July. I have already testified five times before Congress on the role this agency plays in overseeing the futures markets. This enhanced public spotlight, while difficult at times, has helped us make the case for increased funding for the Commission's essential programs and completing the ever-elusive agency reauthorization. I thank all of you who are involved in these efforts and I ask that

you join me in continuing to help advance the long-overdue completion of Reauthorization this year.

While these legislative efforts consumed much of our time during the last six months, the Commission has been very active in the enforcement realm, working with FERC on filing the Amaranth and ETP cases, and working with the Department of Justice to reach a record settlement of $303 million with BP for manipulating the propane market. When you also consider our recent work on Exempt Commercial Markets on top of everything else we have accomplished, I think it is clear that our cup runneth over. Nonetheless, there is more to do.

Now that we are settling into 2008, I hope to pursue an active agenda for the Commission this year that will continue to take our agency and the industry down the path of progress and modernization. I endeavor to do this, however, with the stark backdrop of the recent volatility in the world's financial, equity, and credit markets. The recent credit crunch, seemingly set off by the failure of strong risk management and market discipline in the sub-prime mortgage and securitization sectors, is a reminder to us all that good times can quickly turn bad in the face of complacency and lax standards and practices.

The futures industry thus far has performed well during these times. This is a testament to the nature of these risk management markets and the flexible regulatory framework of the CFMA. Most of you know what a big fan I am of the "principles-based" approach to regulation. The attractiveness of this approach lies in the premise that a rigid prescriptive approach is incompatible with the innovative nature of our markets. Rather, "high level" objectives coupled with detailed guidance provide a more balanced way to achieve regulatory compliance in today's modern economy. What matters in a principles-based approach is not a rigid focus on the means, but the effectiveness of the outcomes achieved.

The principles-based approach does not mean the elimination of all prescriptive rules. Where the risks can be identified with a degree of confidence and the policy concerns are compelling, rules might be the right answer. The protection of customer funds generally falls within this realm. But where a more pliable approach is appropriate, firms should be allowed to innovate and develop. Our challenge is achieving the correct blend between rules and guidance.

I firmly believe that this regulatory approach is the way of the future and is necessary for U.S. markets to compete globally. Last fall, the Department of the Treasury released a request for public input as it prepares a blueprint for an improved U.S. financial regulatory structure. Secretary Paulson asked for public comment on a number of topics including overlapping state and federal regulation, ways to improve market discipline and consumer protection, the strengths and weaknesses of having multiple regulators and multiple federal charters for financial institutions, as well as other issues. I was pleased to see that the request for comment recognized the benefits of the CFTC's principles approach and tiered regulatory structure.

The goal of this blueprint is to seek a more effective regulatory structure that can adapt to the dynamic U.S. marketplace without compromising strong oversight. I agree with many commentators that U.S. financial laws need to be rationalized so that regulators are better able to achieve the public and economic goals of this nation. This is a necessary and critical exercise that hopefully will lead to the strengthening of the U.S. financial markets in the increasingly competitive global marketplace. I understand that Secretary Paulson plans to complete this

regulatory blueprint shortly. I'm looking forward to seeing the final report and hope that the progressive elements of our regulatory structure are recognized.

One important aspect of our regulatory approach is that it encourages a healthy dialogue between the affected industry and the regulator. This helps ensure that the Commission is well informed in making policy decisions and that the benefits of Commission action are properly weighed against the costs of such decisions. Since the enactment of the Commodity Futures Modernization Act in 2000, there is a direct statutory means by which industry may shape Commission regulations. Specifically, Section 5c of the Commodity Exchange Act, relating to Acceptable Business Practices under the Core Principles, provides that the Commission may issue interpretations – here's the important part – or approve interpretations submitted to the Commission, related to contract markets, derivative transaction execution facilities and clearing organizations.

The beauty of this paradigm is that it allows industry participants to create their own acceptable business practices, consistent with the principles, and to submit those to the regulator for approval. Similar to the "notice and comment" concept, this bottom-up approach allows industry participants to take early responsibility for addressing regulatory problems. The organic nature of this process helps ensure that the eventual outcomes consider the costs and benefits to the industry. As the regulator, we welcome this insightful input brought by our market participants and look to this law community to consider developing additional acceptable practices for our consideration.

In today's economic environment, the use of acceptable practices or best practices as a way to change market behavior is gaining momentum. The current market disruptions illustrate what can happen when industry participants become complacent about their own practices, even though they may be following all of their regulators' rules. For example, Soc Gen may have been in compliance with all regulations but the actions of a single trader appear to have caused billions in losses and a worldwide stock market plunge. I am sure we will be hearing more about Soc Gen as the details unfold, but I think it underscores the basic view that smart business practice extends beyond "checklist regulation." There should be a collective effort by regulators and industry to develop best practices for risk management and controls to prevent this sort of massive fraud in the future.

Other effective examples of best practices include the President's Working Group recent work on Hedge Funds. Last February, the PWG released its Hedge Fund Principles designed to guide market participants and supervisors in addressing public policy issues raised by hedge funds including market stability and integrity as well as investor protection.

Following up on the Hedge Fund Principles, in the fall, the PWG announced the formation of two private sector groups to address hedge fund issues and best practices: first, an Asset Managers' Committee was tasked with developing guidelines and best practices for the hedge fund industry to reduce systemic risk and foster investor protection; second, an Investors Committee was tasked to develop standards and guidelines for investors currently in, or considering investments in hedge funds. The success of these acceptable practices hinges on the private sector groups' ability to formulate workable practices that will gain industry and investor buy – in. Having small children, I understand how powerful peer pressure can be in shaping behavior. Conceptually, best practices are a powerful form of industry peer pressure that has proven effective at helping change business culture.

Unfortunately, the Commission has never received a proposed acceptable business practice submitted by this industry for approval pursuant to Section 5c. As we at the Commission work to provide additional guidance to the markets, we hope those of you who work with industry participants will revisit this provision's invitation to submit acceptable practices. As the CFTC staff continues to get comfortable with the transition from prescriptive rules to principles and acceptable practices, it is also imperative that the legal community also buy-in to this new approach and help in its development. I hope that you will partner with us in identifying areas in need of additional guidance and help us put flesh on this new progressive regulatory structure.

I'd like to give you a little preview into areas of Commission focus where acceptable practices might benefit our markets and their participants. Some of these issues are ripe for development now and some have been in the pipeline for some time. Regardless of where each is in its development, I am committed to the Commission's progress on these issues over the next year.

DIRECT ACCESS

The Commission and a number of foreign regulators are reviewing the growing "disintermediation" trend – that is the ability of customers to place trades directly on the exchange, without directly being subject to the risk controls of an FCM. The direct access model has many advantages, such as reducing transaction costs and enhancing trading speed.

But the direct access model raises new challenges for industry and regulator alike. Futures brokers must continue to be able to monitor the credit risk of their customers, regardless of whether such customers place the trade through a broker, or directly with an exchange. We are therefore examining a number of issues relating to direct access, including the processes FCMs utilize before they approve clients for direct access, whether it is feasible for FCMs to set pre-trade risk limits at an exchange where their customer trades, and how quickly FCMs obtain executed trade information from the exchange on which its clients trade.

In order to assist us in these efforts, we asked the futures industry for assistance, and we have already received considerable feedback. Late last year, the FIA submitted a paper summarizing existing risk management arrangements used by both exchanges and FCMs in order to assess clients' risk exposure where customers have direct access to the markets. The FIA's work provides extensive background information, which CFTC staff is currently reviewing. In addition, the Commission is heading a major initiative on an international level through the International Organization of Securities Commissions (IOSCO) on direct access.

After reviewing all of this information, we may call on the industry to do more. In particular, I am hopeful that with the work already completed by the FIA and IOSCO on the direct access issue, the Commission and futures industry can work together to develop clear guidelines with respect to managing client risk.

SRO GUIDANCE

With a great deal of industry input, the Commission has worked on Acceptable Practices for Core Principle 15 to address conflicts of interest inherent to self-regulation of exchanges, and to offer exchange self regulatory organizations (SROs) a safe-harbor for minimizing such conflicts.

To receive safe harbor treatment, the proposal required Designated Contract Markets (DCMs) to implement the Acceptable Practices' in their entirety, including instituting boards of directors that are composed of at least 35% public directors and establishing Regulatory Oversight Committees composed solely of public directors to oversee regulatory functions and to ensure that they remain free from improper influence.

In March 2007, the Commission published proposed amendments to clarify the definition of "public director." Because this issue has not been fully resolved, in November 2007, the Commission put the amendment process temporarily on hold to further review the issue because it is critical that we provide clarity in the definition of "public director". I am committed to finalizing the Commission's work on this issue in early 2008. This is another area where we may call on the industry to provide us with more information as we complete the process.

RECORDKEEPING MODERNIZATION

Recordkeeping is another area where we must continually re-evaluate our rules and determine how to keep pace with an evolving electronic marketplace. Technological advances in the futures markets require us to assess how those changes impact records we need to effectively regulate. We now have audio files, e-mails, text messages, instant messages, and Blogs and all cause us to think about such basic questions, like "what is a record?" or "what must be maintained?"

The CFTC has a recordkeeping task force to assess the continuing developments and needs in this area. This issue is not unique to the CFTC and we plan to look at how our regulatory counterparts, both domestic and international, are addressing the recordkeeping issue. We hope to minimize the burden to industry participants while enhancing our regulatory abilities through the use of acceptable practices or rulemaking on the recordkeeping issue. Since this will certainly affect the day-to-day operations of many market participants, your input will be imperative.

SUPERCLEARING

As globalization of our industry continues at a hearty pace, I expect cross-border clearing issues to continue to arise – either as straightforward requests for designation or approval for various linkages. As you may know, the CFTC has had some experience in looking at cross-border clearing arrangements, including such links as CME-SIMEX, CBOT-LIFFE, USFE-Eurex, CME-MEFF and now CME-CFETS.

Although each cross-border arrangement presents unique attributes, our inquiry should be broadly directed at understanding whether the arrangement in question maintains the safety and soundness of the related designated clearing organizations and whether the proposed conduct requires the foreign partner to seek designation as a designated clearing organization. In this regard, the core principles set out in the CEA for DCOs establishes the primary framework used by the CFTC for examining applicants for designation as well as proposed linkages or other cross-border clearing arrangements.

Even where designation is required, the CFMA provides the CFTC with sufficient flexibility to allow a clearing organization to demonstrate its compliance with a core principle through reliance on some aspects of existing regulatory supervision in the home country. I note that the

CME has taken advantage of such a regime in the UK. In the end, what matters most is compliance with the CEA's core principles, and as this trend continues, the Commission may need additional industry input.

In closing, I would say that I am optimistic about tackling this busy agenda in the coming year. I hope that the industry and agency can work together in the coming year to meet these upcoming challenges. It's a dynamic industry during a dynamic time and it's a privilege to play a role in it. Thank you for your time and for asking to me to speak to you today.