



Commodity Futures Trading Commission

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Speech

**Let's Not "Dial M for Merger":
CFTC's Principles-Based Regulation – A Success Story**

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

before the

**Futures Industry Association, Law and Compliance Luncheon
The Downtown Association
New York, New York
November 13, 2007**

Thank you very much for the invitation to be with you today. It is a pleasure to be with you in New York. Today, I thought we'd discuss a timely (and somewhat provocative) topic – CFTC/SEC merger. Last month Treasury asked for public comment on a blueprint to "streamline" financial services regulation, and for a lot of people "streamlining" is a codeword used as justification for, among other things, a merger of the CFTC and SEC. In case you're wondering, I'm on the "nay" side, but I'll talk more about that in a few moments.

Before we plunge into a discussion of merger, let's take a few moments to discuss something that doesn't get a lot of attention, but should: the CFTC's successful (and sole) exercise of principles-based regulation at the federal level in the United States. This "regulatory revolution" has benefited your industry tremendously, as well as providing tangible benefits to the American taxpayer, and it's worthwhile to take a closer look at this very successful system that we have in place.

REGULATORY REVOLUTION

First of all, let's think about this in some sort of historical context. We can go back to Presidential candidate Reagan, who successfully advocated for tax reform by, in his campaign speeches, holding up an unwieldy mass of US Tax Code, and, with humorous and at the same

time startlingly profound verbal imagery, pointing out that “even Albert Einstein had to write to the IRS for help with his Form 1040.” The result was the Tax Reform Act of 1986.

Al Gore took this imagery a step further when in 1995, he stood next to a fork-lift of discarded federal employment forms to introduce his “Reinvention of Government” and Paperwork Reduction Act initiatives.

Well, I don’t have a stack of futures exchange rule approval forms to throw out the window to illustrate the streamlined rule certification procedure, but what I can tell you is that, principles-based regulation has successfully changed the way we regulate. The CFTC is not the bureaucratic, slow, cumbersome, red-tape regulator that people think of when they think of a federal agency. We are not “command and control” or stove-piped. While that is unfortunately all too often the case in government I can tell you, that is not your regulator today. We are not “your father’s regulator.”

In 2000, Congress passed the Commodity Futures Modernization Act (CFMA) that made a fundamental change in the way the CFTC works—what I’ve referred to as a “regulatory revolution.” What the CFMA did was move to “principles-based regulation,” which means that we set broad principles for which we expect industry adherence. If industry goes too far, we will tell you, but this principles-based approach allows enormous flexibility. It allows the industry and the CFTC to look around the corner, to be nimble and quick and to react – in real time – to changes or potential changes in the marketplace.

Principles-based regulation is in stark contrast to the top down, proscriptive type of regulator that every other agency in United States government – the SEC, USDA and every other agency or department – and indeed, around the world, uses.

In real life, what this means is that instead of, for example, a new product taking six to nine months for approval, exchanges can certify new products and they can be up and running the next day. This allows industry to capture the value of new products without long delays. Which, in turn, helps hedgers, speculators and consumers. And it has helped foster the incredible growth we have seen in the futures industry. For example, the BIS Quarterly Review for September 2007 indicates a remarkable growth in derivative financial instruments traded on organized exchanges in North America—from 82.8 million futures in December 2005 to 121.8 million futures in June 2007 (an increase of 47.4%), and from 43.7 million options in December 2005 to 87.3 million options in June 2007, an incredible increase of 100%.

In addition, the CFTC’s regulatory structure has helped foster a tectonic plate shift in the fundamental way markets are organized: from the traditional, member-owned entities of the former century to the demutualized shareholder-owned businesses of today. And the fruits of that can be seen in the exchanges’ market capitalization figures, which, if you’re not already aware of them, may astound you: as of last Friday, the market cap of the CME Group was \$35.18 billion, compared to the market cap of the New York Stock Exchange at \$23.71 billion and the NASDAQ at \$5.2 billion. That’s right: the market capitalization of the CME Group dwarfs the combined mcap of the two largest stock exchanges in the world.

And the benefits of principles-based regulation are evident not only with regard to the types of traditional regulatory issues I’ve just mentioned: there are also significant benefits to the CFTC’s enforcement program. The simplest example of this relates to use of government

resources in the prosecution of fraud and manipulation in the futures markets. Since we've moved to an oversight type of regulation, the Commission can choose to use our human capital investigating and prosecuting cases, rather than expending resources unnecessarily on, for example, rule submissions that can now be self-certified. We've streamlined our regulatory oversight procedures, and that has resulted in our ability to focus on increasingly complex enforcement cases.

One area that particularly concerns me is the rampant retail forex bucket shop fraud that has proliferated in the United States in the past few years. The numbers are staggering: the CFTC has brought almost 100 cases in this area in the past six years, involving 26,000 victims, and over \$1,000,000,000 in fines and restitution have been assessed. We're continuing to be extremely aggressive in prosecuting cases in this area, despite the setback that we received from Judge Easterbrook in the 7th Circuit Zelener 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, and I'm confident that, with the work of our enforcement division, and possibly some legislative amendments by Congress, the CFTC will continue to make a significant dent in the battle against off-exchange retail forex fraud.

We've changed the way we prosecute to address larger and more complex fraud and manipulation schemes, and principles-based regulation has helped us become the 21st century cops on the beat. 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, at any one time, we are investigating approximately 750 to 1000 individuals and entities. Some are under suspicion of fraud, some for manipulation, and some for a large variety of other potential violations under the Commodity Exchange Act. That's more than two for every CFTC employee.

For all these reasons, it's no wonder that the financial world looks to the United States as a global leader in this industry, and that your markets have contributed so greatly to the economic engine of our democracy. What you do is critically important to the economic health and well-being of our nation, and the CFTC's principles-based regulation has helped to foster that innovation, competition, and remarkable growth.

We have essentially gone from a Rambler station wagon to a Corvette. We are faster, smoother, and more efficient – and we are also a lot more fun.

CFTC/SEC MERGER

On October 11, the Treasury Department released a draft report that contained a "blueprint" to make the U.S. financial regulatory structure more efficient. The Treasury is asking for comment

on how to “streamline” financial services regulation; as I mentioned, the desire for “streamlining” is sometimes used as a justification for merging the SEC and CFTC. In a way, we can liken this to Reagan’s efforts in the 1980s to improve the tax code, Gore’s work in the 1990s to streamline systems and decrease hardcopy paper usage, and Congress’s reinvention in 2000 of the CFTC’s from a “command and control” regulation to an oversight, principles-based system: Treasury is attempting to come up with a better mousetrap. This effort is driven primarily by the perceived need to reduce U.S. regulatory burdens to improve our domestic markets’ ability to compete abroad, a laudable objective. One of the concerns raised in the report is the need to address overlapping and duplicative regulatory authorities between securities and derivatives markets, also a laudable goal.

While potential areas of duplicative regulatory oversight of financial institutions certainly exist (dual regulation of certain financial services conglomerates by the SEC and the Office of Thrift Supervision comes immediately to mind), unfortunately, the first response to Treasury’s duplicative regulatory query for some is, hey, let’s merge the CFTC and SEC. Well, for the reasons I’m going to lay out for you, let’s not “Dial M For Merger.” It would be a grave mistake, would not result in the putative efficiencies espoused by its proponents, and would do nothing in the way of improving the competitiveness of U.S. markets.

The CFTC and the SEC, while both financial regulators, oversee two completely different types of markets, and consequently have two completely differently sets of statutory and regulatory schema. You could put the us both in the same building, but we would still have two different sets of laws to carry out, two different sets of regulatory responsibilities, and two different Congressional mandates. (We just wouldn’t have to walk as far to argue about them.)

There are certainly products, such as derivatives of commodity-based exchange-traded funds, for example, that may appear to fall between the two agencies’ jurisdictional lines. But these hybrid products are going to raise difficult issues regardless of whether there is one regulator or two.

The point is, the alleged efficiencies that the pro-merger proponents espouse just aren’t there. Just look at the merger of securities and futures regulators in the United Kingdom in 2000: at best, it’s equivocal whether that merger resulted in any tangible regulatory efficiencies. In addition, I believe it is intellectually lazy to attempt to justify a proposed merger based on potential efficiencies; there have got to be additional advantages to such drastic change (e.g., competitive advantages), in order to justify the gargantuan costs. And we simply have no evidence of those. It is a given that our system differs from others around the world, but that doesn’t make it inferior, and it certainly doesn’t mean that we should conform to European or Asian models of regulation.

The CFTC has already adopted a principles-based regulatory approach that allows innovation and competition to flourish without undue regulatory impediments and get products to market faster. Its regulatory system is an example of the solution, not the problem. The SEC, on the other hand, is an example of the classic, old-style, prescriptive regulator, and the difference between our two systems shows why it would be such a mistake to merge the SEC and the CFTC. Why would you want to merge an agency with a system that is working well, fostering innovation and competition, with another agency with a fundamentally different mandate?

Let’s touch for a moment on a controversial topic that often comes up in the context of this debate: cross-jurisdictional products. Rather than overreact and jump to agency merger, the

CFTC's experience with cross-jurisdictional products shows that concrete efforts need to be made to harmonize efforts between the CFTC and SEC for these types of products. Improved communication and harmonized approval processes would avoid, for example, the months-long wait that that occurred with the credit event options approval effort. No one benefited from that, and, unfortunately, it only fueled the merger fires. Given the novel issues raised by some of these new products, it could very well take legislation to resolve some of the jurisdictional issues. But at this point, the focus should be on efforts to resolve the actual problems created by two agencies' different statutes and mandates, not merely putting those problems under one roof. What really should be the focus of the conversation is how to improve our lines of communication, not advocating how to fix a regulatory oversight system that isn't broken.

A word of caution former Federal Reserve Board Chairman Alan Greenspan on this topic. Chairman Greenspan noted that, "I feel that we would probably be ill served by too much consolidation because it is very likely to lessen the interest in the development of new products." His warning about stifling innovation certainly has proven true in the past—just look at security futures products, and the moribund growth in those dually-regulated products. It just doesn't make sense to take the CFTC, which has operated so successfully utilizing the principles-based system since 2000, and merge it with an agency whose regulatory philosophy is fundamentally incompatible with such an approach.

All too often, prescriptive rules and regulations don't anticipate potential issues, or conversely, they go too far and over-prescribe solutions to problems that don't exist. Someone once said, "If all you've got is a hammer, everything looks like a nail." Well, if all you've got in your command and control regulatory toolbox is one thing, that's what you're going to pound away with, right or wrong. The CFTC's principles-based regulation gives it the flexibility to select (or allow the market to select) the right regulatory tool for the job. The SEC doesn't approach things that way because that's not their regulatory system, and it would be a mistake to lose the flexibility the CFTC has by merging it with the SEC.

Proponents of merger should be asked to specify what further efficiencies and economies would be generated by merging the CFTC with another agency with a fundamentally different approach. From what we've seen abroad, the results aren't there to justify merger of the two agencies based on efficiency or competitiveness arguments. Unless and until we see that, I remain firmly on the "no merger" side of the line.

CONCLUSION

Once again, it is a pleasure to be with you today. Let me just say that 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. It is important to your industry and it is important to our country. Thank you.