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Speech

"Sense of Balance"

Speech of CFTC Commissioner Bart Chilton before the American Public Gas Association Annual Meeting, Indianapolis, Indiana

August 4, 2009

Introduction

Good morning. Thank you for that introduction Tommy Miller, and congratulations on your new leadership role at APGA. I also want to thank Bert Kalisch, your President and Chief Executive Officer, and Dave Schryver, your Executive Vice President; both are marvelous hosts and do a great job for you. Thank you and your board members for the invitation to join you today in Indianapolis. I spoke with your board nearly two years ago. Perhaps they thought I was odd enough to provide you with some entertainment, had something to say about some pretty important issues—maybe even both—since they approve of me being here now. That and President Barack Obama declined. There is always that.

I spent my youth in Indiana. I loved going to the Indy 500 as a kid—the single largest day in sports with over 400,000 fans. I also went to school at Purdue just up the road from here. So, it is a pleasure to be with you—particularly in Indiana.

Andretti—Not Fast Enough

One of my favorite quotes is from, arguably, the greatest racecar driver in history: Mario Andretti. In fact, he won Rookie of the Year after his first Indy 500 in 1965 where he finished third. Four years later, he won the race. After winning here at Indianapolis, he went on to win the Daytona 500, the Formula One World Championship—along with over 100 other races. He drove all types of cars: sports cars, sprint cars, stock cars—you name, it he drove it. He raced on all types of tracks, too: on ovals, on road courses, even on drag strips. He won "Driver of the Year" at some point during each of the 60s, 70s and 80s. Up until golfer Tom Watson's performance at age 59 at the British Open last month, one could argue that Andretti outperformed and outlasted most of those in all of sport. Anyway, his quote that I am so fond of is this: "If everything seems under control, you're just not going fast enough."

Well, I am not sure that financial markets are under control, but regulation of these markets is not moving fast enough for me. We agree that Congress should extend current market monitoring practices by authorizing the Commodity Futures Trading Commission (CFTC) to collect information concerning all positions held by the largest traders in the natural gas derivatives market. I also think we need to go further and look at other contracts, not just Nat Gas.

The CFTC could have done better during the price run up in energy markets last year. To some extent, we did not fully exercise our due diligence on market oversight. I am not faulting our staff or saying we did not meet our official obligations under the law. However, sometimes you need to go further, to go "faster"—as Andretti would say. As a regulator, we need to be nimble and quick, to be looking constantly down the track and around the curve at what might happen and how we should prepare for those possibilities. We did not do that last year to the extent we should have.

Hearings

That said, we are on a fresh road now. Our new Chairman, Gary Gensler, has been inquisitive, proactive and thoughtful. I strongly supported his efforts to convene hearings this summer to address excessive speculation issues in commodity markets, particularly energy markets. As many of you know, Laura Campbell testified last week and as usual, she did a fantastic job on behalf of APGA. However, literally within a day or so of the announcement of these hearings, the pushback began: a chorus of voices warning against overreaching regulatory action and urging the CFTC not to move too fast on its oversight agenda.

Andretti would cringe at such a "go-slow" approach. As disappointing as they were, those requests were expected. Changes to address unwarranted speculative activity—possible imposition of limits on futures trading in energy commodities and redefining the concept of "true" hedging—could, if enacted, affect the way many have done business for decades. Taking into account, however, the unprecedented volatility in commodity markets over the past year, the links with international markets, and the resulting harm to ultimate consumers worldwide, the only responsible answer to these requests has got to be that, in whatever manner the agency proceeds, "going slow" is not an option.

That does not mean we will act capriciously or irresponsibly; the twin objectives of speed and wisdom are not mutually exclusive. It does mean that we need the best and brightest minds, like Laura's, brought to bear quickly on these issues, to determine an appropriate regulatory response.

The naysayers use a common debating tactic, that is, to frame the debate as a choice of unreasonable alternatives. This forces deliberations off-course, driving proponents to argue against one straw man after another. For example, the "go slows" argue that any changes to speculative or hedging rules will impair the ability of markets to effectively discover prices, or move market participants into opaque markets, or negatively affect the ability to effectively manage risks, or unfairly impact consumer prices. The CFTC would not of course enact policy changes with those objectives or outcomes, yet all of these charges were raised—even before the first word of testimony was spoken.

Sense of Balance

The real policy debate in the current matter—and the real work to be done—centers on a shared fundamental vision and lexicon. The words “speculation” and “hedging” are all too often bandied about, without a great appreciation for their multi-layered and interdependent meanings.

Let us start with the premise that speculation is not a four-letter word. Speculators play a critically important and valuable role in the hedging and price discovery process in futures markets. They provide liquidity for the commercial hedgers in the marketplace and, traditionally, eliminate much of the volatility. However, there needs to be a sense of balance between the amount of commercial hedging and the amount of speculation going on in these markets. Where is that balance? That is the policy debate that the CFTC hearings are intended to develop. Where is that balance?

Who remembers the Flying Wallendas? The family’s circus act dates back to the 1780s, but many of us remember them from the Ed Sullivan Show and their famous flying trapeze and tight rope walks. They toured as part of the "Greatest Show On Earth"—headlining with the Ringling Brothers, Barnum & Bailey Circus and on at least one occasion performed without a net when that very important piece of equipment was lost in transit. Hence, some say, was the inspiration for the phrase “working without a net.” The Wallendas’ early featured act was a harrowing four-person, three-level pyramid. On a wire 50 feet in the air, two men rode bicycles and on their shoulders rested a bar, which supported a chair upon which family patriarch Karl Wallenda balanced, with his wife Helen standing on his shoulders. Now *that* is a balancing act!

It was at a single performance in neighboring Ohio that a loose wire triggered the near-tragic fall of the four Wallendas from their pyramid. The following day’s news story told of the tremendous grace with which each had individually fallen onto the wire, miraculously avoiding injury. The writer equated their nimble recoveries to flying, and the headline was written “The Flying Wallendas.” Together the Wallendas managed life-threatening risks by perfecting a sense of balance in perilous circumstances. Like them, we need to adapt quickly and “in-balance” to market changes and dynamics.

Markets Have Changed

There is no doubt that futures markets have changed. They are no longer dominated by commercial hedgers, like utilities, refiners and airlines, but today are flush with “new, non-traditional” participants, such as pension funds, university endowments, hedge funds and index portfolios. This new asset class of investors views the energy complex of commodities not as a hedge against energy costs, but as an investment to protect against long-term inflation and a way to diversify portfolios. The new traders play a large role—some would say an excessively large role—in the buy-side of the market, and, unlike traditional futures trading, they stay in the market for extended periods of time, often continuously rolling from one delivery period to another. This represents a tectonic plate shift in futures market operation, requiring that we re-evaluate the applicability of decades-old rules in light of new market conditions.

These are free markets, and investors have a right to enter and exit as they deem suits their business needs. The CFTC has never been in the business of saying, “you are not tall enough to ride this ride,” or “there’s no more room for investors here.” We *are* in the business, however, of ensuring that actions of market participants, individually or as a group, do not have unintended or uneconomic effects on our markets or on prices. They should not be operating—like the Flying Wallendas—without a net. The delicate balancing act of maintaining both free markets, as well as markets free of uneconomic effects is part of our job at the CFTC.

That is why the hearings are an excellent forum to discuss ways to ensure that speculative activity in the marketplace does not distort prices. First, we need to look at the issue of spec limits generally; we have federally set spec limits in ags, but not in other physically delivered commodities, like Nat Gas and the rest of the energy complex and like the metals complex. We need to see if it is appropriate for the CFTC to set limits in those commodities as well. I personally think we need to look carefully at that. That's not based upon a hunch or tarot cards; it is based upon what I've seen in these markets. The accountability levels are abrogated all too often, and sometimes quite significantly.

For example, the accountability level for Nat Gas for a single month is 6,000 contracts, yet 40 traders abrogated those levels in the last year. They did not go over for a day or two either; the average numbers of days in excess of the accountability level was for—get this—84 days. The average size of the positions held by those traders was 11,720—nearly twice as high as the accountability level. For all contract months combined, the accountability level is 12,000 contracts; yet, 26 traders abrogated those levels for an average of 80 days with an average of 44,835 contracts. Okay, let us review, the accountability level is 12,000 and they averaged 44,835. In addition, if 44,000 is the average, we know that some traders had much higher levels. Accountability levels are like Andretti with "suggested" speed limits on a dark desert highway. Not much attention is paid to them.

Oil is certainly as important a commodity as wheat, and, last summer we saw the price of oil skyrocket out of control. It's now over $70 a barrel—a 60% increase since the beginning of this year, and that's in the face of the highest supply and lowest demand in the last decade. It is possible that federally set spec limits could provide some needed "speed bumps" for this market.

Second, we need to look at whether exemptions that have been granted with regard to these limits are appropriate. This involves a review of our fundamental concept of "bona fide hedging": specifically, should that include entities that are primarily involved in financial hedging, and not in the actual commercial dealings in underlying commodities? We need to drill down on this issue, and figure out how best to construct this definition to protect consumers and markets. We need an in-depth and comprehensive analysis, to ensure that appropriate speculative activity is permitted, but that activity causing uneconomic price moves is prohibited.

Regulatory Reform

At the same time we are moving forward expeditiously with our hearings and proposed rulemaking, we need to make clear to Congress that our part is only one tier in the oversight pyramid. Without regulatory reform of our derivatives laws, whatever we do could have a perverse impact on markets and consumers. For example, if we do not strike the right balance, and limit positions too much, the argument goes that we could send trading overseas, where they could be less regulated, and not benefit the U.S.

economy. Alternatively, we inadvertently could send this trading to dark markets—the over-the-counter (OTC) markets that are virtually unregulated. These are the same unregulated markets where credit default swaps, or CDSs, were traded and sent AIG (American International Group) to the federal piggy bank to avoid total devastation.

In this regard, the President has asked us to look ahead and “build something better.” In June, the Obama Administration proposed a comprehensive reform proposal for the nation’s financial regulatory system, and it is in the fine-tuning of this Herculean effort that there is a rare opportunity and responsibility to rise to the President’s call and challenge, to truly create a better financial market oversight system for the American public—businesses and consumers.

In addition to oversight and regulation of OTC products, the proposal calls for comprehensive regulation of such swaps transactions, like CDSs, including, among other things, clearing of all “standardized” OTC products through regulated central counterparties. Other regulatory reforms for OTC products include recordkeeping and reporting requirements, business conduct standards, capital and margin requirements, enforcement authorities, position limits and limitations on participants. These are all important and necessary improvements to the current oversight system (or rather, the lack thereof).

It’s time to put some meat on the bones of this discussion, and start talking about what it means to be a “standardized” OTC transaction, and therefore required to be cleared. Does that mean looking at volume of trading? Contract terms? Are the prices disseminated to the public? Is it a “price discovery contract?” How large is the group of offerees to the contract? Who are the offerees? Or do we look at a combination of some or all of these factors? Whatever the answer, I think it’s time (perhaps past time) to get concrete in our discussions about this issue, and develop some objective criteria.

Transparency

A critical component of everything we do is adding appropriate transparency to these markets. We are already doing more to enhance transparency. As some of you may be aware, we finally are revamping of our Commitment of Traders (COT) reports. This is intended to 1) separate swaps dealers out of the current commercial category, 2) separate hedge funds and other managed accounts out of the current non-commercial category, 3) include data from foreign contracts that are "linked" to domestically traded contracts, and 4) include data from significant price discovery contracts. I look forward to getting comment from the public as to what they think of this new report format, and whether additional improvements can be made.

We used to put out a report with a bunch of columns and numbers that if you graphed it would show the trend of a particular contract—Nat Gas or whatever. Now, the large investment banks have economists doing that graphing, the hedge funds have folks doing it, other sophisticated traders have folks with degrees in economics doing it. In fact, we at the CFTC have people doing it all the time. You should see the wonderful power points and graphs we get to see all the time. Now, you can. But guess what, we did not offer that to the public—at least not until recently. One of our primary jobs needs to be increased transparency. Moreover, if something as simple as graphing complicated charts will help small investors, we not only need to do it, we should have been doing it for a long time. In addition, we need and accept feedback on how we could be doing it better.

Criminal Authority

As we look to finally getting all of these things in place at the CFTC with position limits, hedge exemptions, etc, and needed regulatory reforms from Congress, I am hopeful that a little-known provision will also be added to the legislation that Congress approves criminal authority for the CFTC. This is important, and here's why: as a financial regulator, we need to be taken seriously. Today, by ourselves, there is very little we can do other than to fine folks and put them out of the business under our Act's civil authority. Our ability to enforce laws, position limits, hedge exemptions, our anti-fraud and Ponzi-related provisions, manipulation and abuse regulations are all impacted by the inability to ensure that crooks go to jail if they deserve it. We need the ability to ensure proper punishment. As regulators, we need to do all we can to ensure that those who do the crime do the time, not just pay the fine.

Currently, two-thirds of our case referrals to the US Department of Justice and other criminal authorities are rejected. That is not because the cases are not meritorious. In fact, we still go forward with the cases and guess what? A full 100 percent of the cases are successful. That's right we have successful outcomes every time. These cases are good, but to be candid, sometimes they are complicated cases involving futures laws with which criminal authorities may be unfamiliar. They may take longer to prosecute than other cases. Whatever the reason, a violation of the Commodity Exchange Act should be appropriately punished. Without criminal authority, our ability to have a deterrent effect and to put people away is severely limited. A provision was incorporated into a bill under the leadership of House Agriculture Committee Chairman Collin Peterson, which passed the Committee with bipartisan support. While I am concerned that jurisdictional issues will stall this particular provision, I am hopeful that this change will move forward in the regulatory reform bill that finally emerges from Congress and is signed by the President.

Close

We have many issues that need attention. We are pressing the accelerator and moving faster. As long as we do that with a sense of balance, and with the views of folks like you and others, we will make significant and clear progress and remain true to our mission mandate and mantra to guard against fraud, abuse and manipulation. We will do more to ensure that markets operate efficiently and effectively and that we do our jobs to protect consumers.

Thank you for your attention. I look forward to working with you as we go forward to address many of these challenges.