



U.S. Commodity Futures Trading Commission

Rules for Principles and Principles for Rules: Making Sense of Financial Regulation

October 24, 2019

Chairman Heath Tarbert

2019 Annual Robert Glauber Lecture



**HARVARD
Kennedy
School**

CFTC Disclaimer

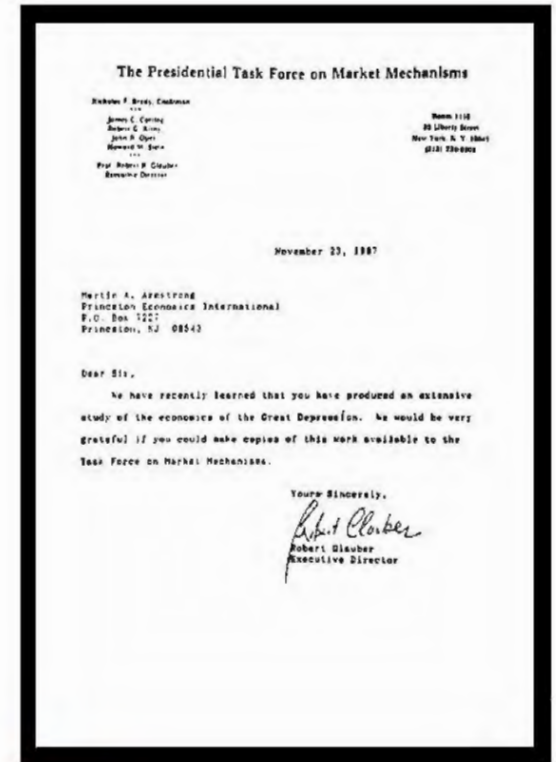
The opinions, analyses, and conclusions expressed herein are those of the presenter and do not necessarily reflect the views of other Commissioners or the Commission itself.

(but I sure hope they might someday....)

Hon. Bob Glauber



Robert Glauber



I. Overview

- Principles–Based vs. Rules–Based Regulation
- Advantages and Disadvantages of Each
- Factors in Choosing Each Approach
- Potential Applications

Why Harvard?



II. Background

Who is the CFTC?

Mission: To promote the integrity, resilience, and vibrancy of the U.S. derivatives markets through sound regulation.



Vision: To be the global standard for sound derivatives regulation.

Signing of the CFMA (2000)





Statements from Former CFTC Officials

- CFTC Commissioner Bart Chilton: “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.”
- Acting CFTC Chairman Walter Lukken: “I believe the CFTC’s principles-based regulatory approach, in combination with its real-time enforcement arm, will continue to be effective in policing our markets and allowing this industry to continue on its upward path of growth.”
- CFTC Chairman Timothy Massad: “While our rules already require [cybersecurity testing] generally, the measures we will consider today add greater definition – not by being overly prescriptive, but by setting some principles-based standards rooted in industry best practices.”
- CFTC Chairman J. Christopher Giancarlo: “We must reconsider and repurpose our analog rules for today’s digital markets. At the CFTC, this can only be done with a return to its traditional approach of principles-based regulation.”



III. Principles-Based Regulation: An Overview

Characteristics of Principles-Based Regulation

- High level of generality
- Focus on outcomes
- Qualitative rather than quantitative
- Susceptible to elaboration





**Please
drive with
care**

Principles-Based Regulation ≠ “Light Touch”



"I wish we'd had light touch regulation."

IV. Advantages of Principles-Based Regulation



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Code of Federal Regulations

Total Pages, Code of Federal Regulations (1950 - 2016)



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“If you make ten thousand regulations
you destroy all respect for the law.”

– Winston Churchill,
House of Commons,
February 3, 1949

Financial Regulations: 13,365 Pages!



Key Advantages

- **Simplicity**
- **Flexibility**
- **Avoids Over/Under-Inclusion**
- **Promotes Innovation**
- **Discourages Loophole Behavior**
- **Creates Better Supervisory Model**
- **Facilitates International Cooperation**

V. Advantages of Rules-Based Regulation

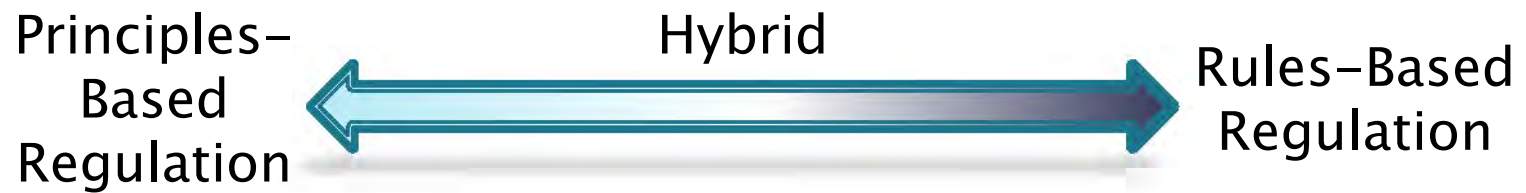
Key Advantages

- Greater Clarity
- Avoids Retrospectivity
- Protects Against Some Private Lawsuits
- Avoids Inefficient “Race to the Top”

VI. How do we choose?



It is not all or nothing....





“[A] principles approach does not obviate the need for rules. Rather, a principles system is a hybrid of desired public outcomes complimented by specific rules aimed at achieving those ends. *Each regulatory authority – depending on the maturity of its markets – will need to find the optimal balance between the flexibility of principles and the legal certainty provided by rules.*”

– CFTC Commissioner Walter Lukken, “Smart Regulation for the Global Marketplace” (2007)

“Rules for Principles”: Factors Favoring the Use of Principles

- (1) Regulatory Objectives
- (2) Nature of the Market/Subject Matter
- (3) Attributes of Market Participants
- (4) Qualities of the Regulator

1. Regulatory Objectives

- A chief objective is prudential supervision.
- Quick action is needed for standards or guidelines for market behavior.
- Direct involvement of senior management in compliance is a desired objective.
- There are several ways to achieve the desired regulatory outcome.

2. Nature of the Market/Subject Matter

- Detailed rules could be easily “gamed.”
- Specific rules governing behavior or processes would require frequent updating by regulation.
- Regulation focuses on rapidly changing technology.
- The regulated market and its products are in the nascent phase.

3. Attributes of Market Participants

- Participants are generally sophisticated, i.e., institutional rather than retail.
- Information asymmetry among participants is neither significant nor structural.
- Participants have existing extensive internal compliance functions.
- Participants are subject to a self-regulatory regime.

4. Qualities of the Regulator

- There is a high-level of trust and frequent interaction between the regulator and the regulated entity.
- There is information asymmetry between regulators and regulated entities.
- Private litigation is generally not used to reinforce the regulator's regime.
- The regulator closely coordinates with its overseas counterparts to promote basic international standards.

“Principles for Rules”: Factors Favoring the Use of Rules

- (1) Regulatory Objectives
- (2) Nature of the Market/Subject Matter
- (3) Attributes of Market Participants
- (4) Qualities of the Regulator

1. Regulatory Objectives

- A chief objective is market conduct or disclosure regulation.
- Clarity of desired behavior is a key regulatory objective.
- The regulation targets behavior that is generally *malum in se*.
- The regulatory outcome can be achieved only by a specific method of compliance.

2. Nature of the Market/Subject Matter

- Imposition of broad principles would lead to confusion and inconsistent behavior.
- Specific rules governing behavior or processes would likely stand the test of time.
- The subject matter involves standard forms or disclosures.
- The regulated market and its products are relatively mature.

3. Attributes of Market Participants

- The market largely comprises consumers, retail investors, or other relatively unsophisticated participants.
- Information asymmetry among participants is significant and structural.
- Participants would prefer transparency and consistency from the regulator rather than flexibility.
- There is no self-regulatory regime governing all or most market participants.

4. Qualities of the Regulator

- The regulator and regulated market participants do not interact on a regular basis.
- The regulator must coordinate its regime with one or more domestic regulators.
- Private litigation plays a significant role in enforcement of the regulatory framework.
- The regulated market has little connection with overseas markets.

VII. Potential Applications for the Derivatives Markets

Automated Trading

Principles-Based



Position Limits

Rules-Based

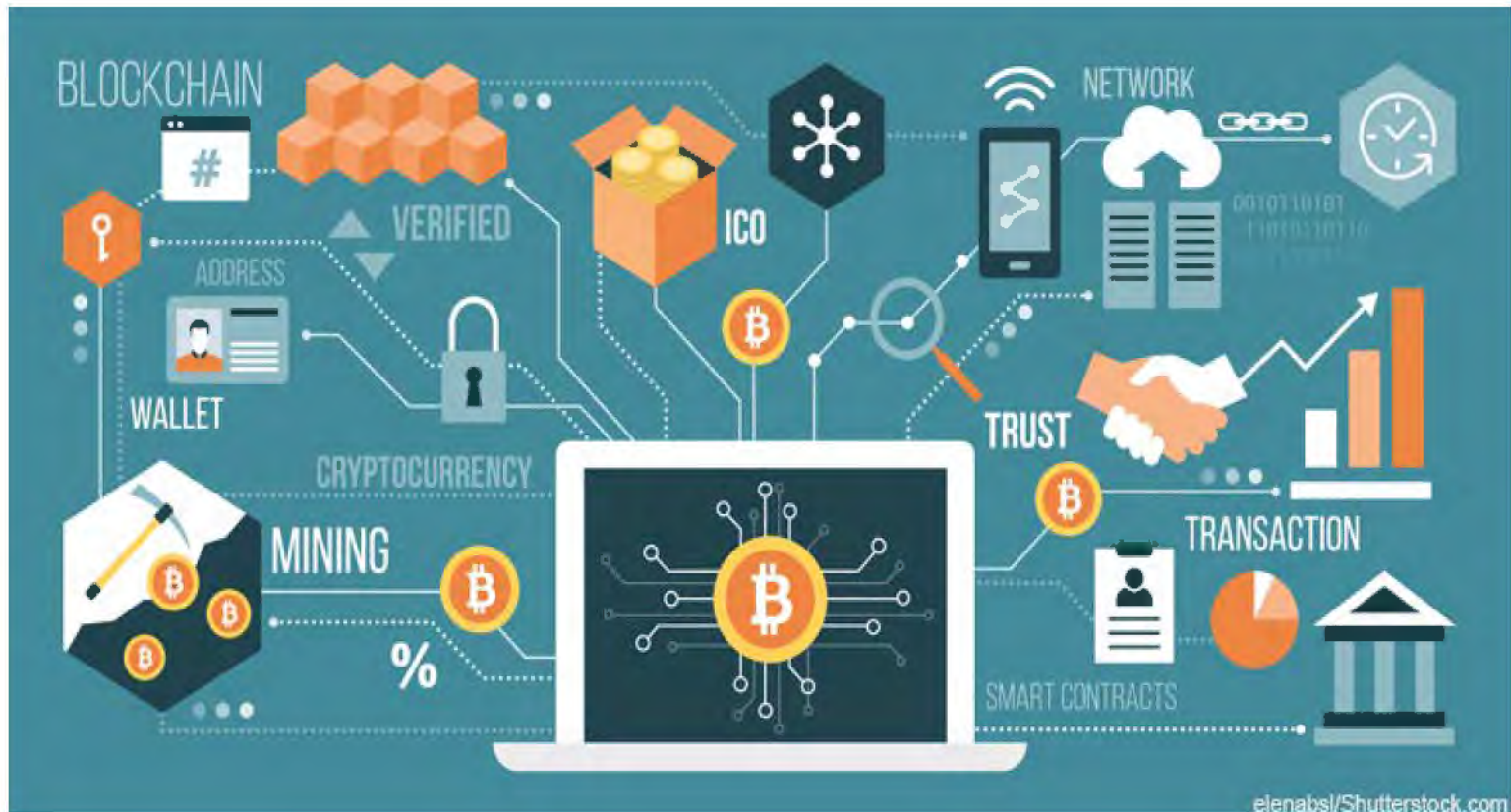


Cross-Border Hybrid



Crypto Assets

Principles-Based \Rightarrow Hybrid



VIII. Final Thoughts

“Let us not seek the Republican answer or the Democratic answer, but the right answer. Let us not seek to fix the blame for the past. Let us accept our own responsibility for the future.”

– John F. Kennedy

Questions?