Testimony of Commissioner Bart Chilton

Commodity Futures Trading Commission

Before the

United States Senate Committee on Agriculture, Nutrition, and Forestry

September 30, 2009

Madame Chair, Senator Chambliss and members of the Committee, thank you for the opportunity to be before you, yet again. It's a particular honor to be here today as one of the first witnesses, at the first hearing to be gaveled by the hand of the first woman chair of this Committee in its illustrious 184-year history. There have been 48 chairmen of the Committee since 1825, and some great ones at that—including some Senators who still serve. However, there has never been a woman or an Arkansan as Chair, and I feel very privileged to be here at this moment in history.

I have testified before the Committee each of the last two years. Last year, I gave what I called a "report" on my first year at the CFTC. I'd like to do that now, and like last year, I'll be brief.

The futures industry was not at ground zero of the "crecession"—that is, the credit crisis and the recession. The Commodity Exchange Act (CEA) and the amendments thereto have worked fairly well—as have these markets for most of their more than 150-year history. That said, this is not only an opportune time to look at what we can and should do better, but it is also a propitious time to review how we are moving forward to continue to ensure that these markets are efficient and effective and that we do all we can to avoid fraud, abuse and manipulation.

New Speculators

First, there is still debate about what impact new speculative activity has had in these markets, particularly as we saw a commodity bubble last year. Some say a lot, some say none, some say a little. Here is what I know: approximately $200 billion went into these markets in the last few years from a new asset class of non-traditional investors. Many of them are what I've called the "new speculators," that is, pension funds, university endowments, state and local governments and index traders who generally take and hold long positions indefinitely. These new speculators are a different phenomenon in the futures markets, which have traditionally been populated by commercial traders—those with a business interest in the underlying physical commodity—and traditional speculators—those who go in and out of the markets, providing liquidity for hedgers, based on their judgments of price movements. The new speculators have a different modus operandi. They get in the markets, by and large, and stay there—most of the time regardless of price. They are passive long traders who are betting that the price of a commodity will be worth more in a time certain—say five years—than it is today. They don't alter their trading strategy on daily prices or other information coming into the markets—this is sometimes referred to as being "price insensitive." As regulators, we need to be aware of the potential effects and activities of these new participants in the markets, and what their impact may be on traditional market users and the primary functions of the futures markets, that is, price discovery and risk management.

My take on this is that the new speculators have had an impact. That impact was likely divorced from the fundamentals of supply and demand, and has effected farmers putting seed in the ground, consumers and businesses putting gas in their cars and trucks, and families putting food on their tables. I'm not suggesting that the new speculators are necessarily the primary "drivers" of commodity prices, but I think they have had an impact. So, what do we do, as regulators, with that?

Under the Commodity Exchange Act (CEA) Section 3, a fundamental mission of the CFTC is to guard against fraud, abuse and manipulation. That means taking some precautions. In my mind, we need to do this in a way that doesn't roil markets and that doesn't send trading to less regulated venues or to overseas trading platforms.

Position Limits/Hedge Exemptions

Given the amount of volatility we've seen over the last two years in commodity prices, it makes sense for us to review limits on the amount of positions that traders can hold and also to look at exemptions to those limits. We have had position limits in the agriculture commodities since the 1940s, and they seem to have worked pretty well (although we have certainly seen some significant hiccups in the last two years). I don't know why appropriate position limits wouldn't make sense in the other physical commodity markets, specifically, energy and metals. That's one of the benefits of principles-based regulation: it allows us to innovate, bring something new and needed to markets as we see it's required. We certainly need to strike the right balance, but since our obligation under the law is to guard against, among other things, manipulation, this seems like an appropriate course to pursue.

The Commission is currently considering what appropriate action(s) we can take in this regard and I commend CFTC Chairman Gensler for holding a series of hearings this summer on these specific topics.

Whatever we do, or don't do for that matter, we need to account for the markets we don't observe. The CFTC does not have a full-landscape view of the derivatives markets and as a result, we cannot protect consumers as we should. The over-the-counter (OTC) markets are comprised of billions upon billions of dollars of unregulated trading. This is where credit default swaps began trading, metastasized among traders, and then played such a significant part in the crecession. All of these trades were done out of the view of regulators. I do care about larger OTC trading that could have an impact upon the currently regulated exchanges, or upon price. I care about OTC look-alike contracts traded on exempt platforms—just as I care about look-alike contracts on Foreign Boards of Trade (FBOTs). I don't know that as a regulator, however, just how much I should care about insignificant bilateral trades between say, a grain elevator and a large producer, if that transaction doesn't affect commodity prices or extend beyond local commerce. But as I say, I'd like more of a panoptic view of all markets, and that means looking at OTC trades in some significant fashion. It also means having regulatory and enforcement authority over these currently unregulated markets.

The Commission is currently considering what we can do, in appropriate fashion through our rulemaking, on position limits and hedge exemption. Whatever we do, assuming we do anything, we need to do that with an eye toward the OTC markets. Some have suggested that if we impose position limits on the regulated exchanges that the trading will simply move to the OTC markets or overseas. That is a good point, and whatever we do needs to be done in light of what the Congress may do with regard to OTC trading as part of a regulatory reform measure. While I do not think that the CFTC must wait on Congress to act on regulatory reform, I do believe we need to be cognizant of the entire environment in which we are operating and ensure that whatever we do doesn't have a perverse impact on markets, traders, or most importantly, upon consumers.

Manipulation

The issues I've addressed have been the subject of many hearings and written about in the news media, but they are important so I wanted to mention them once again. There are, however, three other issues I wanted to raise that have not received as much attention.

First, I think Congress—and specifically this Committee—should seriously consider changing our manipulation standard. It's an opportune time to address this, inasmuch as you have the issue of financial regulatory reform on your agenda. Just a few weeks ago, we had two days of hearings with the Securities and Exchange Commissioner (SEC). These were historic in that the Commissioners of the two agencies had never met in a public setting before. They were long overdue given the myriad issues of mutual interest between the two agencies. One issue that I highlighted (and our Chairman also raised questions on this point), is the varying manipulation standards. If you compare the agencies' manipulation standards, the SEC has an easier legal hurdle to jump, and I think this may be a great opportunity to adjust our standard to be more in line with theirs, particularly in light of the Administration's call that our agencies harmonize our rules and regulations. The Federal Energy Regulatory Commission (FERC) and the Federal Trade Commission (FTC) have standards similar to the SEC's manipulation standard.

To be more specific, under applicable case law the CFTC is required to prove "specific intent" to manipulate. That is a very difficult standard to reach, not to mention that it leaves a lot of wiggle room for mischief that is clearly prohibited by the Act, yet not categorically outlawed. It would be extraordinarily unlikely that any individual, for example, would explicitly write in an e-mail that he or she specifically intends to manipulate prices. But that's what our law currently requires. In fact, this standard is so high that in the CFTC's 35-year history, while we have settled numerous manipulation cases, we have only successfully prosecuted and won one single case of manipulation in the futures markets! Only one. And that case, the DiPlacido matter, is currently on appeal in federal court.

In addition, our case law requires that we prove an artificial price exists, that the defendant had market power to move the price, and the he or she actually did cause the artificial price. Particularly in today's complex markets, proving "artificial price" can be a daunting task, which more often than not comes down to a "battle of the experts" in court. Because these requirements are so onerous, we often end up moving to a lesser charge of "attempted manipulation," which requires only proving intent and some act showing that intent. This is still a high standard, but is much easier than proving up a full manipulation case. Again, we've been very successful over the years, particularly in the energy arena, in obtaining significant settlements in attempted manipulation cases, but we've not had success in litigated cases because of our very difficult manipulation standard.

The Securities and Exchange Commission (SEC), on the other hand, under its "10b-5 rule" has a different, easier-to-prove manipulation standard. Basically, they are not required to prove specific intent, as we are, they just must prove that the defendant acted "recklessly." I'm not saying that the answer is wholesale adoption of the SEC manipulation standard, but clearly, as Senator Cantwell and others have recently noted, we need to do something different at the CFTC. The status quo simply isn't good enough.

A recent federal court case in Texas exemplifies the need to amend our manipulation standard. In 2007, the CFTC settled the BP manipulation case for an unprecedented amount of $303 million—the largest settlement in the history of the CFTC. The Department of Justice (DOJ) followed that case by bringing a criminal case against four of the participants in the scheme. Two weeks ago, the Texas judge in that case had to throw out the manipulation charge against those four, because (although he made it clear he didn't condone their behavior) he said that, in essence, the CFTC manipulation standard simply could not be met. Clearly, the current standard is not working.

I would point out that, in looking at other jurisdictions around the world, virtually all nations have rules prohibiting this type of conduct, and it is a criminal offense in many of those jurisdictions, entailing significant sanctions. In this country, our current standard in the futures arena is ineffectual. It is not sufficient to fully prosecute and deter abuses in the markets, and I'm hopeful that in working with Congress, we can all move forward on figuring this out.

Criminal Authority

Another issue that I think deserves more attention—related to our manipulation standard and enforcement efforts—is criminal authority. Neither the CFTC nor the SEC, the two principal federal financial regulators responsible for policing the exchange trading markets in the United States, has legal authority to put bad guys in jail. Both have authority to bring cases in federal court against fraudsters and scam artists, but the only penalties in their regulatory arsenals are civil—monetary fines, for example. The Federal responsibility for putting people behind bars is reserved, currently, for DOJ. And the reality, unfortunately, is this: it is becoming tougher and tougher to incarcerate felons because of a lack of legal authority—criminal authority—for financial regulators.

Violations of commodities and securities laws often involve highly technical and complicated trading schemes. To prosecute these violations effectively, attorneys and investigators must be experts in the complex functioning of these markets. SEC and CFTC enforcement personnel are specially trained to handle these matters, unlike DOJ prosecutors who are more likely to be unfamiliar with the mechanics of financial trading and the interstices of federal financial laws and regulations. That doesn't mean that there aren't very qualified DOJ attorneys who understand futures law. There are some, but not enough. While DOJ attorneys do an excellent job in their prosecutorial functions, it is simply asking too much to expect them to be expert in the types of complexities that commodities and securities professionals deal with on a daily basis. It is perhaps understandable why it is difficult to get them to commit scarce resources to prosecute complicated financial fraud and manipulation cases.

Since 2002, the CFTC has referred over 100 cases to DOJ and other criminal authorities (such as state and local law enforcement bodies). Unfortunately, two-thirds of those criminal referrals have been rejected. One might think that we aren't sending them good criminal cases, but that's not the situation. In fact, in 100 percent of those matters, the CFTC moves forward and we reach a favorable outcome for the government.

The bottom line is that folks who do the crime often only pay the fine and don't do the time. Other financial regulators around the world—in the United Kingdom, Australia, Hong Kong, and Japan, for example—already have such criminal authorities. Chairman Peterson of the House Agriculture Committee has taken a leadership role on this issue, resulting in passage by his Committee of a provision that would grant the CFTC such authority. I understand that this raises jurisdictional issues—both in Congress and with DOJ. Perhaps there are good reasons that this should not be done. So far, I haven't heard those reasons. I have heard that , "It has never been done." I have also heard that, "Only DOJ should handle such cases since they are the Executive Branch." But, what are we? The CFTC is part of the Executive Branch. Granted we are an independent agency, and perhaps that raises issues that cause some concern. Again, however, I haven't heard a good argument against this proposal. Certainly, I'm hopeful that congress will consider this change.

Consumers

Finally, I think the Commission needs to revitalize its commitment to educating, protecting and advocating for the investing public. The futures markets of today are not the same as they were even three years ago, and that is, in part, due to new participants. With the advent of new and novel products, and the crecession, the investing public are now moving their assets into the futures markets with exponential momentum, and they are sometimes doing so without full and complete understanding of the nature of the investments or strategies.

The CEA specifically empowers the CFTC to engage in education and outreach efforts to protect market participants from fraudulent and other abusive sales practices, and I am committed to a renewed effort to provide consumers with information they need and want regarding financial investing. We need to become a more user-friendly public resource for investors and prospective investors. Only through increased financial literacy will the investing public be better able to navigate the investment choices currently before them. I'm committed to providing this resource to American consumers to provide the protections and information they need and deserve.

Thank you for the opportunity to be with you today. I’d be pleased to answer any questions at the appropriate point.