KEYNOTE ADDRESS

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It is a pleasure to be here at the *Administrative Law Review*'s 2008 Energy Law Symposium and join alumnus and Federal Energy Regulatory Commission (FERC) Chairman Joe Kelliher at the podium. I appreciate the University's invitation to participate in this discussion on the important topic of regulation of the energy markets. From recent market events, it is clear that energy will be at the forefront of our national discussions for many years to come.

When I first introduce myself to people and explain what I do for a living, their normal response is often the following: "May you live in interesting times." The more I heard this statement, the more I wanted to understand its origin. It turns out that this saying is derived from ancient China and rather than being a glass-half-full sort of comment, I found out it was meant as a curse more than an off-handed blessing. Certainly if energy prices are volatile on a given day, it feels like a curse.

This curse of volatile energy prices is one that is felt by all Americans. These issues are a matter of intense focus at the Commodity Futures Trading Commission (CFTC) due to the key role that futures markets play in the price discovery process for commodities, and this Commission is closely scrutinizing the current regulatory structure given the seismic changes that have occurred in these markets.

These days the entire financial system is at the center of the nation's attention, and an intense debate rages about the current state of the financial markets and the root causes of recent instability. We at the CFTC have

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been closely monitoring the events unfolding each day—both in the markets and on Capitol Hill—and we have worked hard to ensure that, through these turbulent times, the futures markets are functioning to provide transparent pricing and centralized clearing to reduce counterparty risk in the system. The Lehman Brothers bankruptcy a few weeks ago tested our regulatory safeguards aimed at protecting customer funds and the integrity of the futures markets. The staff of our Division of Clearing and Intermediary Oversight was on-site in New York during this critical time, working tirelessly to ensure futures customers were protected. I am proud of the work of our agency during this time, knowing that when tested—in a time of crisis—both our laws and staff met the challenge. The next Administration and Congress will likely tackle wholesale regulatory reform next year, and recent market events certainly underscore the importance of updating the overall regulatory structure for Wall Street. The CFTC stands ready to be a part of that dialogue and to highlight the need to protect customers in its markets and to uphold the integrity and reliability of the markets' price discovery function.

Against this turbulent backdrop, we continue to pursue the regulatory principles I charted for the agency when I assumed the position of Acting Chairman last summer. Since that time we have tackled what seems like a lifetime's worth of challenging regulatory issues. The initiatives I have pursued, including enhanced market transparency and controls coupled with aggressive enforcement, are even more important during these volatile market conditions.

Over the past year, the Commission has undertaken several steps directed at enhancing the oversight of the energy markets. These initiatives fall into four broad categories: (1) increasing transparency and market controls, (2) pursuing aggressive enforcement, (3) improving regulatory coordination, and (4) seeking more cops on the beat. I'd like to walk through these four steps one by one.

Step One: Increasing Transparency and Market Controls

One of the core missions of the CFTC is protecting the sanctity of the central price discovery process on futures exchanges. If prices are not reflecting the fundamental factors of supply and demand, the futures markets are not functioning properly, and all Americans suffer. If there is a lack of confidence in the validity of the price of a commodity, commercial participants will be less likely to manage risk in the futures markets. Furthermore, those involved with the commercial merchandising of a physical commodity, such as a utility or power generator, will be hesitant to forward contracts with customers if there is doubt about the basis of a price discovered on the futures markets. This is why the CFTC's core mission of protecting the central price discovery process is so important.

The proper protection of price discovery begins with transparency. Market regulators must receive the necessary information to conduct surveillance of market activity and evaluate policy changes as circumstances evolve. The backbone of the CFTC's market surveillance program is the large trader reporting system. All large traders must file daily with the CFTC their futures and options positions in the markets. This information enables the CFTC's surveillance economists to oversee all traders of size to ensure that no one is attempting to manipulate the futures markets.

In addition to transparency, the CFTC imposes position controls on certain markets to ensure that one trader does not control too large of a position to corner or squeeze the markets. This combination of transparency and market controls has historically worked well in protecting the sanctity of prices discovered on the futures markets. Since our creation thirty-three years ago, this mission was relatively straightforward: to enforce and police. The centralized futures market was its own distinct market—price discovery occurred at brick-and-mortar exchanges under the watchful eye of one federal regulator.

But with the advent of electronic trading and globalization, we have witnessed the development of satellite markets that complement and compete with the centralized and regulated futures markets. First was the growth of the over-the-counter (OTC) swaps market that formed, allowing Wall Street institutions to customize and tailor risk-management products for commercial users of those commodities beyond standardized futures markets. Swap dealers offer these individualized OTC products to their customers, then combine and offset this risk before bringing the residual price risk to the futures markets.

As these off-exchange swaps markets developed, customers sought more efficient ways to trade these instruments, and as a result, electronic trading platforms—called exempt commercial markets (ECMs)—began to form. The most prominent ECM is the Intercontinental Exchange in Atlanta (ICE).

While these satellite markets brought innovation and competition, they also complicated the regulatory focus and mission of this agency due to the potential influence these entities could have on the central price discovery process that occurs in the futures markets. Just as the moon has the ability to affect the earth's tides, these satellite markets with direct links to the central futures market have the ability to influence the price formation of commodities.

Over the last year, the CFTC has systematically been reviewing these developments to determine whether these satellite markets have had an impact on the centralized price discovery process and to make regulatory adjustments as needed. My tenure as Acting Chairman of the CFTC began with an examination of the trading of natural gas contracts on ECMs. Last fall the Commission held a public hearing relating to natural gas trading on ECMs. This resulted in CFTC legislative recommendations for Congress, which were ultimately made law as part of the recently enacted Farm Bill.[1] Those new authorities include the requirement that the CFTC receive large trader information from the markets and that the exchange imposes position limits and accountability levels for certain contracts.

Linkages between contracts are not purely a domestic occurrence but also happen across international borders. The CFTC announced earlier this summer certain modifications to its Foreign Board of Trade recognition process, including enhanced information sharing and position and accountability limits that are comparable to the regulated U.S. contracts that serve as the foreign contract price reference. These improvements were necessary due to the possibility that these linked foreign markets could influence prices on the centralized futures market *in the United States*. It was not done in an effort to oversee *foreign* exchanges that are regulated by their home regulators. This combination of enhanced information data and additional market controls will help the CFTC in its surveillance of its regulated domestic exchanges while preserving the benefits of its Foreign Board of Trade recognition program.

Lastly, the CFTC has taken action to improve the transparency of swap dealers and index traders in the energy markets. There is public concern about the amount of long-term commodity index investments flowing into the futures markets and the potential impact it may have on commodity prices. This summer the CFTC used its special call authority to gather more detailed data dating back to December 31, 2007, from swap dealers on the amount of index trading occurring in the over-the-counter markets and to examine whether index traders are properly classified for regulatory and reporting purposes. This was an unprecedented action, given that the CFTC regulates on-exchange futures contracts and does not have specific jurisdiction of over-the-counter swaps.

The CFTC staff report[2] found that on June 30, 2008, the total net amount of commodity index trading—both OTC and on-exchange activity—stood

1. Food Conservation and Energy Act of 2008, Pub. L. No. 110-234, 122 Stat. 923 (2008) (to be codified in scattered sections of 7 U.S.C.).

2. COMMODITY FUTURES TRADING COMM'N, STAFF REPORT ON COMMODITY SWAP DEALERS AND INDEX TRADERS WITH COMMISSION RECOMMENDATIONS (2008), *available at* http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/cftcstaffreportonswapdealers09.pdf.

at $200 billion. Of this amount, $161 billion was tied to commodities traded on U.S. markets regulated by the CFTC. Although a sizeable amount of this $161 billion figure may not reach the futures markets due to internal netting by swap dealers, to put the number in context, it represents 17% of the roughly one trillion dollars of notional value for these same commodities traded on-exchange.

For New York Mercantile Exchange (NYMEX) crude oil, the net notional amount of commodity index investment rose from about $39 billion in December to $51 billion in June—an increase of more than 30%. However, this rise appears to have resulted from the increase in the price of oil, which rose from approximately $96 per barrel to $140 per barrel over that period. Measured in standardized futures contract equivalents, these figures equate to an 11% decline in aggregate positions of commodity index participants during this six-month period.

Staff also looked to determine whether the clients of swaps dealers were putting on positions that would have exceeded exchange position limits or accountability levels when combined with the clients' on-exchange positions. Looking at our most recent snapshot of June 30, of the 550 clients identified in the more than thirty markets analyzed, the survey data shows thirty-five instances across thirteen markets where noncommercial traders appeared to have an aggregate on-exchange and OTC position above a speculative limit or an exchange accountability level.

While these combined positions do not violate current regulations and the excess amounts were generally small, information regarding those who significantly exceeded limits or levels would be useful in the CFTC's surveillance of the futures markets.

In light of the preliminary data and findings, the Commission made several recommendations, including the enhancement of transparency for both public-reporting purposes for futures contracts and OTC swaps contracts, the creation of a CFTC office of data collection, and the replacement of the bona fide hedge exemption for swap dealers with a new limited risk-management exemption.

While the report's findings are useful and instructive, the data collection and analysis need to continue if the agency is to get a clearer picture of this vast marketplace. However, these preliminary recommendations represent enhanced transparency, increased reporting and information, and improved controls and practices used to oversee the markets while keeping our futures markets competitive, open, and on U.S. soil.

Step Two: Continuing Aggressive Enforcement

During these turbulent market conditions for energy products, the environment is ripe for those wanting to illegally manipulate the markets, and as a result, the Commission has stepped up its already aggressive enforcement presence. In June, the Commission took the extraordinary step of disclosing that, in December 2007, its Division of Enforcement launched a nationwide crude oil investigation into practices surrounding the purchase, transportation, storage, and trading of crude oil and related derivatives contracts.

In July, the CFTC announced the first case stemming from its national crude oil investigation.[3] The CFTC charged the proprietary trading firm Optiver and several related defendants with manipulation and attempted manipulation on multiple occasions of energy futures contracts traded on the NYMEX, including crude oil, heating oil, and gasoline. As alleged in the complaint, on several days in March 2007, Optiver's traders amassed large positions in several energy contracts and then conducted trading in a way so as to "bully" and "hammer" the markets to benefit their positions.

These charges go to the heart of the CFTC's core mission of detecting and rooting out illegal and intentional manipulation of the markets. As with most of our manipulation cases, this alleged activity was meant to artificially move prices for short, discrete periods of time—in this case, temporarily moving prices up or down for several minutes over certain days in March 2007. But even such short-term distortions of prices will not be tolerated by the Commission, and the Commission will fully utilize its enforcement powers to track down anyone who is illegally trying to game the markets.

The Commission's Division of Enforcement has also been watching the markets closely over the last several weeks. On September 22, 2008, we announced that our Enforcement Division would be looking into that day's trading in crude oil when prices spiked over $16 per barrel in the last day of trading for the October contract. Our Enforcement Division prides itself on its "real time" enforcement of the Commodity Exchange Act,[4] and quick responsiveness is imperative to maintaining confidence in the markets, especially during these tumultuous times.

Step Three: Improving Oversight Coordination

Given the CFTC's limited size and the enormity of the global marketplace, the CFTC must also engage others in government as we seek to meet our important mission. The regulatory structure over the energy

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3. Complaint for Injunctive and Other Equitable Relief and Civil Monetary Penalties Under the Commodity Exchange Act, U.S. Commodity Futures Trading Comm'n v. Optiver U.S., L.L.C., No. 08 Civ. 6560 (S.D.N.Y. July 24, 2008).

4. Commodity Exchange Act, 7 U.S.C. §§ 1–27f (2006).

space is one that assigns multiple tasks to multiple regulators. At the CFTC, we have worked closely with our regulatory partners at the Securities and Exchange Commission (SEC), Federal Energy Regulatory Commission (FERC), Federal Trade Commission (FTC), and with our cooperative partners in criminal prosecutions at the Department of Justice. Recent legislative developments have made clear Congress's intent that multiple regulators should work together to ensure there are no gaps in the oversight of important markets like the energy markets. We have long had productive relationships working with our sister regulatory agencies, and I intend to continue down that path to provide market oversight that is comprehensive and beneficial. Where the regulatory boundaries of the various agencies meet or overlap it is not surprising that everyone involved is aggressively pursuing action to the fullest extent of their jurisdiction. I am hopeful that in those places where sincere differences of opinion exist as to the boundaries of that jurisdiction, the courts will be able to resolve those issues quickly. Both Chairman Kelliher and I have respectfully acknowledged that the agencies have a difference of legal opinion on the issue of the CFTC's exclusive jurisdiction that will likely be resolved by the courts. But, rest assured, the CFTC and FERC stand shoulder to shoulder in the goal of ensuring that the energy markets remain free from manipulation.

The CFTC has pursued other cooperative government initiatives in the energy markets. In June, the CFTC announced the formation of an Interagency Task Force to evaluate developments in the commodity markets, which includes economic staff from the CFTC, Federal Reserve, Treasury, Energy, and Agriculture Departments as well as other agencies. It is intended to bring together the best financial minds in government to aid public and regulatory understanding of the forces that are affecting the functioning of these markets. The Task Force issued an interim report[5] on the crude oil markets in July and aims to issue its final report in the fall.

On the international front, yesterday the International Organization of Securities Commissions—the global standard-setting body for financial market regulators—announced that the CFTC and the United Kingdom Financial Services Authority would lead a Task Force on Commodity Markets to share thoughts on enhancing regulation for these markets with our international regulatory counterparts and coordinate supervisory approaches. I look forward to co-leading this cooperative effort.

An emerging and developing area of the energy space that will certainly

5. INTERAGENCY TASK FORCE ON COMMODITY MKTS., INTERIM REPORT ON CRUDE OIL (2008), *available at* http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/itfinterimreportoncrudeoil0708.pdf.

require cooperative regulatory action is in carbon emissions. Just as we work with cash regulators in the energy, financial, and agricultural sectors, we expect that with a further development of carbon trading, the CFTC will partner with the cash market regulator—such as the EPA—to ensure the futures markets in carbon are reliable markets for price discovery. The CFTC's expertise in futures and the fact that it already regulates both the Chicago Climate Exchange and the Green Exchange makes it uniquely situated to regulate the complexities of futures trading even where another regulator, such as the EPA, contributes its own expertise in regulating the underlying commodity. I expect that as the carbon-emissions markets develop and attract more users, the CFTC will play an important role in shaping the carbon futures markets and making sure the protections provided by the Commodity Exchange Act extend to these new developing exchanges.

Step Four: Seeking More Cops on the Beat

All of these new initiatives are resource and staff intensive, but I believe they are critical to help us properly oversee our markets. In addition to these latest proposals, it is also important to remember that we are full-time regulators overseeing these markets each and every day. To say we are busy is a gross understatement, especially given that our staffing levels are near record-low numbers. Since the CFTC opened its doors thirty-three years ago, the volume on futures exchanges has grown 8,000% while the CFTC's staffing numbers have fallen 12%.

This agency is only 450 individuals strong—roughly one-third the size of FERC and one-eighth the size of the SEC—but we oversee $5 trillion worth of notional financial flows in our markets daily. It is imperative that the CFTC receive the additional resources commensurate with the public responsibilities expected of it.

In closing, there are challenging days ahead for regulators and these markets, including finding near-term ways to stabilize and shore up the financial and energy markets. But I remain optimistic about the ingenuity of the American spirit to overcome these challenges during these "interesting" economic times. The American people have always overcome obstacles in our path, and I am confident that we will greet these challenges with hard work and entrepreneurial determination.