"Almost Certainly MSU (making stuff up)"[1]

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Remarks by Commissioner Scott D. O'Malia

Commodity Futures Trading Commission

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Introduction

I would like to begin by thanking Professor Pirrong and UH-GEMI for inviting me to today's conference. It is a pleasure to be here with all of you. For those of you who don't know me, prior to joining the Commodity Futures Trading Commission (the "CFTC" or "Commission"), I spent about 18 years working in and with the energy industry. I worked in the U.S. Senate for 16 years, focusing on energy policy. I also spent two years at Mirant Energy, a competitive wholesale electricity company, where I focused on corporate risk management and energy trading. I witnessed firsthand both California's energy crisis and Enron's financial meltdown. Those experiences opened my eyes to the troubles caused by flawed market design and inadequate oversight.

It was a time of great regulatory flexibility, and rather unfortunately, some took advantage of weaknesses in the system. But, the Commodity Futures Modernization Act of 2000 (the "CFMA") affirmed and strengthened the CFTC's role as overseer of the futures and related markets. The CFTC aggressively pursued a campaign to restore market integrity and put an end to abusive practices by prosecuting close to 50 individuals and entities and assessing close to $300 million in penalties for false reporting and attempted manipulation in energy markets. The industry responded in part by reevaluating its own risk management controls.

Shaken by Enron's fall from grace and the revelation that the "Crooked E's" business model was built on fraud and deceit, the energy industry took it upon itself to adopt two significant reforms. First, the energy industry established the Committee of Chief Risk Officers ("CCRO"). This group, which I was directly involved with, developed industry best practices to put an end to and further prevent the manipulative trading behavior deployed by Enron and others. The CCRO continues to develop and implement improved risk management and transparency best practices in the industry. Second, the industry embraced clearing of energy contracts through the platforms of both the IntercontinentalExchange ("ICE") and the New York Mercantile Exchange (NYMEX). With the collapse of Enron, the merchant energy companies saw their credit downgraded and their collateral requirements increase. Clearing offered the best solution to mitigating counterparty credit risk. Both reforms were unquestionably positive for the industry.

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[1] Pirrong, Craig. "Can't Have it Both Ways, Bart." Streetwise Professor. Craig Pirrong. Mar. 8, 2012. Web. Mar. 9, 2012.

Then in 2008, the global financial crisis resulted in the collapse of large financial institutions, significant government intervention in the form of private enterprise bailouts, and downturns in stock markets around the world. In response, Congress passed the Dodd-Frank Act, which significantly transformed the Commodity Exchange Act (the "CEA").

We are now in a new era of regulation. It is my hope, consistent with the Dodd-Frank Act, that the Commission's rulemaking efforts surgically fix what is broken while providing market participants with the ability to encourage market growth. In developing reforms, it is important to keep in mind that, while Dodd-Frank utilizes the futures markets as a model for the swaps markets, there remain important attributes that make the two markets distinct. The futures and swap markets developed as parallel markets. The Dodd-Frank approach to regulating swaps in the same manner as regulating futures puts the CFTC in a formidable and precarious position. We must of utilize our expertise to implement statutory objectives in a manner that preserves swaps market utility in the midst of forced structural change.

In implementing the provisions and objectives of the Dodd-Frank Act, the Commission must give appropriate deference to the unique traits of each market while ensuring that the resultant set of regulations are not so operationally burdensome and complex that the costs of compliance and implementation immobilize the markets (and the regulators), causing far greater harm to commodity prices and the economy as a whole than the events that led us to this point. The costs imposed by our rulemakings should be carefully monitored to ensure that they bear an appropriate relationship to the desired benefits.

I came to the Commission at an exciting time. I haven't been shy about voicing my concerns that the Commission has taken too many liberties with regard to cost-benefit analyses, the presentation of options and regulatory alternatives, and explaining its rationales in issuing many of the mandatory and discretionary rulemakings under Dodd-Frank. On more than a handful of occasions, I have sat at open Commission meetings and struggled to recreate the analytical or statutory process that brought us to many final rules. Today, I would like to talk about two issues that, in my mind, call into question whether the underlying facts and analyses behind the Commission's rulemakings are sustainable, and whether the Commission has been transparent where the statutory language of the Dodd-Frank Act is ambiguous: the Commission's cost-benefit analyses and the exchange trading requirement of the Commission's proposed Core Principle 9. I would also like to continue with the theme of transparency in the face of ambiguity and talk about the latest attempt to address the role of price reporting agencies in the energy and other markets on an international scale.

Cost Benefit Analysis – Getting it Right the First Time

Recently, I have been dubbed a "rogue commissioner" and an "entrepreneurial obstructionist" by the cable TV talking heads for citing specific examples of where the Commission has failed to meet basic standards in analyzing the costs and benefits of its rulemakings. Also, for pointing out where such failure has been persistent and systematic. I earned these accolades as a result of writing a letter to the Office of Management and Budget ("OMB") requesting that it conduct an independent review of the Commission's most recent cost-benefit analysis and submission under the Congressional Review Act. I did not request OMB to conduct a new cost-benefit analysis; I simply requested that OMB audit our methodologies and analyses to gauge compliance with OMB best practices. My concerns are two-fold. First, taking shortcuts in our rulemakings today could result in legal challenges in the future on both substantive and procedural grounds. Second, conducting appropriate and thorough cost-benefit analyses provides greater opportunities to identify and appropriately consider options and alternatives while exploring areas for potential regulatory harmonization and efficiency.

My request hardly warrants the unbefitting label of "guerrilla warfare," but, again, we are in a time of great partisan hyperbole. As our very own Streetwise Professor has recently noted, there is usually an easy answer for this kind of confusion with regard to facts – commonly diagnosed as MSU—making stuff up. I can hardly believe the argument of my opponents is that the Commission has lower standards and should not be held to anything higher. Essentially, they ask that we all just lower our expectations.

Where We Are in the Process

Before I go any further, I think it is helpful to set the stage for where we are in the process right now. Including the rules we voted to finalize just a few days ago, the Commission has completed 29 rules, with just over 20 more to complete. The Chairman anticipates that the Commission will complete most of its rule-writing by this summer, but concedes that it is likely that a handful won't be finished until later this year. In the more immediate future, it is conceivable that rules with regard to designated contract markets ("DCMs"), and rules defining entities and the end-user exception, could be calendared for final vote sometime in late April or May.

Of the 29 rules that have gone final, ten have been designated as "Major Rules" under the Congressional Review Act, meaning that OMB's Administrator of the Office of Information and Regulatory Affairs ("OIRA") has determined that <u>each</u> of these rules will result in or is likely to result in: (1) an annual effect on the economy of $100 million or more; (2) a major increase in costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or (3) significant adverse effects on competition, employment, investment, productivity, innovation, or the ability of U.S.-based enterprises to compete with foreign-based enterprises in domestic and export markets.[2]

Of the ten, nine such determinations were based solely on the representations by Commission staff that the rule in question would have an annual effect of $100 million or more on the economy. The interesting point about this is that the Commission has produced little to no specific data to justify its calculations in any of these rules. The Internal Business Conduct rule[3] is the most recent rule to earn the coveted "MSU for Rulemaking" Award.

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[2] *See* 5 U.S.C. §804(2).

[3] Swap Dealer and Major Swap Participant Recordkeeping and Reporting, Duties, and Conflicts of Interest Policies and Procedures; Futures Commission Merchant and Introducing Broker Conflicts of Interest Policies and Procedures; Swap Dealer, Major Swap Participant, and Futures Commission Merchant Chief Compliance Officer,

Some have argued that the Commission is paralyzed by fear and has been unable to move forward due to the threat of challenge to our cost-benefit analyses. Let me remind everyone that we have completed 29 final rules, with 10 designated as "Major Rules." Last year, the independent agencies combined finalized just 17 Major Rules[4], so this assertion just doesn't hold water. We are moving at a breakneck pace.

"Close Enough for Government Work" Isn't Good Enough

I was reminded on Tuesday at the Commission's public meeting that, in applying the cost-benefit provisions of the CEA, found in section 15, the Commission is not required to quantify the costs and benefits of new regulation or to even determine whether the benefits of a proposed regulation outweigh its costs.[5] "Rather, section 15 simply requires the Commission to 'consider the costs and benefits' of its action."[6] That was a direct quote from the Commission regarding its interpretation of section 15, which occurred simultaneously with the Commission's first rulemaking requiring application of section 15 in 2001. Commenters to that proposal do not appear to have questioned the Commission's interpretation of the requirements of section 15, and thus, about five months after the proposal, the precedent was set forth in a final rule.[7]

In my very first public statements with regard to these Dodd-Frank rulemakings, I stated that the best results are gained from honest, principled reform that gives everyone a fair shake. In that first Dodd-Frank speech, I stated that:

> "Honest reform focuses on solving problems and balancing inequities—we should draft regulations and make policy decisions supported by empirical data, and be careful not to overstep our bounds. Principled reform focuses on the core mission of this agency—protecting market participants from abuse and fostering

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__ Fed. Reg. __ (__ __, 2012) (to be codified at 17 C.F.R. pts 1, 3, and 23), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister022312b.pdf.

[4] Office of Management and Budget, Office of Information and Regulatory Affairs, 2011 Report to Congress on the Benefits and Costs of Federal Regulations and Unfunded Mandates on State, Local, and Tribal Entities, *available at* http://www.whitehouse.gov/sites/default/files/omb/inforeg/2011_cb/2011_cba_report.pdf.

[5] A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations, 66 Fed. Reg. 14,262, 14,267 (proposed Mar. 9, 2001) (to be codified at 17 C.F.R. pts. 1,5,15,36,37,38,40, 41, 100, 166, 170, and 180.

[6] *Id.*

[7] A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations, 66 Fed 42,256, 42,267 (Aug. 10, 2011) (to be codified at 17 C.F.R. pts. 1,5,15,36,37,38,40, 41, 100, 166, 170, and 180) (The Commission understands that, by its terms, section 15 does not require the Commission to quantify the costs and benefits of a new regulation or to determine whether the benefits of the proposed regulation outweigh its costs. Rather, section 15 simply requires the Commission to "consider the costs and benefits" of its action.).

> open, competitive, and financially sound markets. Rulemakings must be transparent, logical, and predictable."[8]

In later remarks and public statements, I reiterated that we must ensure that our rules are accessible, consistent, written in plain language, guided by empirical data, and are easily understood. I cautioned that, with each piecemeal rulemaking, we risk creating redundancies and inconsistencies that result in costs—both opportunity costs and economic costs—without corresponding benefits.

Consistent with the President's Executive Order 13,563, which reaffirms prior guidance on the subject of regulatory review issued in the 1993 Executive Order 12,866[9] as well as OMB guidance to federal agencies with respect to said Executive Order[10], it is my opinion that all federal agencies must go out of their way to ensure responsible rulemaking by, among other things, undertaking thorough cost-benefit analyses, both qualitatively and quantitatively, to ensure that new rules do not impose unreasonable costs.[11] We must uphold the mission put upon this administration by the President, "[T]o root out regulations that conflict, that are not worth the cost, or that are just plain dumb,"[12] and, in the words of OIRA Administrator Cass Sunstein, "promote good government by reflection and choice."[13] It is through cost-benefit analysis that agencies are able to engage affected stakeholders, explore options, and make informed decisions based on facts. Cost-benefit analysis is not just a box to check.

Five Easy Ways to Improve the Commission's Cost Benefit Analysis

One should never highlight problems without offering solutions. In the Twitter-saturated media market, everyone likes a quick and dirty "how to" list. I have come up with five easy reforms that the CFTC could implement to improve our cost-benefit analyses. First, our staff must perform research and analysis that involves some level of independent information gathering, quantitative analysis and industry query prior to the proposal stage of rules and policy decisions. By soliciting ideas from the industry, the Commission can take a more holistic approach to evaluating alternatives, understanding costs and benefits (both qualitative and quantitative), and developing flexible approaches in final regulations. The point is that cost-benefit analysis is not an add-on; it is an integral part of the process. Second, whether we are proposing or finalizing rules, we must present the public with the considered alternative regulatory and policy solutions and outline why we have adopted or rejected any such proposals. We did this with the Block

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[8] Scott D. O'Malia, Commissioner Commodity Futures Trading Commission, Keynote Address at 13th Annual Energy and Commodities Conference (Oct. 14, 2010), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-2.

[9] Exec. Order No.12,866, 58 Fed. Reg. 51,735 (Oct. 4, 1993).

[10] OMB Circular A-4, available at http://www.whitehouse.gov/sites/default/files/omb/assets/regulatory_matters_pdf/a-4.pdf.

[11] *See* Opening Statement of Commissioner Scott D. O'Malia Regarding Open Meeting on One Final Rule and One Proposed Rule, Feb. 23, 2012, *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliastatement022312.

[12] Barack Obama, Toward a 21st-Century Regulatory System, WALL ST. J., Jan. 18, 2011, at A17.

[13] Cass Sunstein, A Regulatory System for the Twenty-First Century, Nov. 30, 2011, *available at* http://www.whitehouse.gov/sites/default/files/omb/inforeg/speeches/a-regulatory-system-for-the-twenty-first_century-11-30-2011.pdf

Rule re-proposal[14], where we provided five policy alternatives, and that was a good first step to changing our process. Third, rules should reflect a coordinated and harmonized approach both within the Commission and with our fellow financial regulators. We need to consider the cumulative effects of other CFTC regulations as well as those of fellow prudential regulators that may also apply. This is particularly important with the swap dealer definition rule, capital and margin rules, and swap execution facility ("SEF") rules. Fourth, we must publicly disclose our internal research to validate our analysis consistent with OMB guidance. Finally, we must put an end to the practice of allowing Dodd-Frank to be the baseline and only estimate changes that go beyond Dodd-Frank. Only in Washington could we ignore the status quo as the baseline.

"What is Working and What Isn't"

Many of you are aware that I sent a letter to OMB requesting their "professional assistance" in reviewing our cost benefit standards, as they are the regulatory standards setting body for our government and the President reminded us of this in his Executive Order. The letter was sent on February 23, 2012.[15] I asked that, "To the extent that OMB finds any concerns with the Commission's economic analysis, I hope that it will provide specific recommendations as to how the Commission can improve its cost-benefit analysis and analytical capabilities," and more specifically that OMB, "determine whether or not the Commission has set the appropriate baseline, included appropriate alternatives, and used proper economic analysis that can be reproduced."

OMB has not officially responded to my letter. However, several media outlets, and a self-described "nonprofit, nonpartisan organization that promotes the public interest in financial reform in the domestic and global capital and commodity markets"[16] have eagerly informed me that, because the CFTC is an independent agency, it "does not answer to OMB," "it is not subject to the standards of cost benefit analysis on which the Request is based," and that, "while the president issued executive orders in 2011 urging regulators to avoid issuing or revise [sic] overly burdensome rules, neither order applies."[17]

As well, an official from OIRA communicated to Chris Hayes of MSNBC that, "If the request for assistance came from an agency, we could offer assistance, but it does not."[18] Oddly enough, this past Tuesday, OIRA Administrator Cass Sunstein issued a memorandum to the heads of

[14] Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, 77 Fed. Reg. 15,460 (proposed Mar. 15, 2012) (to be codified at 17 C.F.R. pt. 43.

[15] Letter from Scott D. O'Malia, Commissioner Commodity Futures Trading Commission, to Jeffrey Zients, Acting Director of OMB (Feb. 23, 2012), a*vailable at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/omalialetter022312.pdf

[16] Better Markets Calls on OMB to Reject Recent Request to Weaken New Financial Reform Rules, Feb. 29, 2012, *available at* http://www.bettermarkets.com/reform-news/better-markets-calls-omb-reject-recent-request-weaken-new-financial-reform-rules

[17] Zach Carter, Scott O'Malia, Commodity Futures Trading Commissioner, Seeks to Upend Wall Street Reform, Huffington Post, Mar. 1, 2012, *available at* http://www.huffingtonpost.com/2012/03/01/scott-omalia-commodity-futures-trading-commission-wall-street-reform_n_1314104.html.

[18] *Up with Chris Hayes: Roadblocks to Financial-Reform* (MSNBC television broadcast Mar. 10, 2012), *available at* http://upwithchrishayes.msnbc.msn.com/_news/2012/03/10/10635371-roadblocks-to-financial-reform-regulations.

executive departments and agencies on the subject of cumulative effects of regulations.[19] The purpose of the memorandum was to provide guidance to all executive agencies on the appropriate manner in which to conduct rigorous cost-benefit analyses and to consider the cumulative impacts of their regulatory actions in light of new and existing regulations.

Specifically, the Administrator's memorandum clarifies that, among other things, executive agencies should: (1) avoid unnecessary and inconsistent requirements; (2) improve regulatory outcomes by engaging in early and close consultation with affected stakeholders; and (3) coordinate the timing, content and requirements of multiple rulemakings that are contemplated for a particular industry or sector, so as to increase the net benefits.

While this memorandum was not written in response to my February 23rd letter, it is responsive in that it confirms my position that the Commission should fully embrace the higher standards expressed in Executive Order 13,563[20], and embodied in Tuesday's memorandum in developing its cost-benefit analyses for all pending and future rulemakings implementing financial reform under the Dodd-Frank Act. Many of you are familiar with the adage, "Close enough for government work." I will not accept that. The Commission must do a better job in consulting with the public as it develops sweeping economic reform. It must develop consistent baselines based on the status quo, include regulatory and policy alternatives and fulsome discussion as to the ultimate choices, and provide publicly available, reproducible quantitative analysis. We should wholeheartedly accept OMB's guidance when available, seek technical guidance as needed, and constantly explore "what is working, and what isn't."[21] We can begin by ensuring that our rules are informed, evidence-based and data-driven. Simply stated; no MSU.

Core Principle 9: We need to 86 the 85-percent Rule

Another example of MSU can be found in the Commission's proposal to abandon the successful core principle regime currently in place for designated contract markets ("DCMs") and replace it with a prescriptive, rules-based system.[22] As I have alluded to earlier, the post-CFMA era and the Commission's core principle regime generally have worked well, providing futures market participants, exchanges and clearinghouses with the flexibility to adapt to changing market conditions. Over the last decade, this principles-based regime has allowed DCMs and futures clearinghouses to experience unparalleled growth and innovation. Recognizing that the U.S. commodities and futures markets weathered the 2008 and 2009 financial crisis far better than other financial markets, Congress did not direct the Commission to prescribe inflexible rules for

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[19] OMB Memorandum, Memorandum for the Heads of Executive Departments and Agencies: Cumulative Effects of Regulations (Mar. 20, 2012), *available at* http://www.whitehouse.gov/sites/default/files/omb/assets/inforeg/cumulative-effects-guidance.pdf.

[20] Executive Order 13,563 was released on January 18, 2011, and directs executive agencies to maintain high standards in developing their cost-benefit analyses. On July 11, 2011, the President issued further direction in Executive Order 13,579, which applied the same standards of Executive Order 13,563, to independent regulatory agencies. *See* Exec. Order No. 13,563, 76 Fed. Reg. 3821 (Jan. 21, 2011); Exec. Order No. 13,579, 76 Fed. Reg. 41,587 (July 14, 2011).

[21] Sunstein, *supra* note 13.

[22] Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80,572 (proposed Dec. 22, 2010) (to be codified at 17 C.F.R. pts. 1, 16, and 38).

DCMs that impose the Commission's business judgments on nearly every operational aspect of derivatives trading.

The most troubling part of the Commission's proposal is an 85-percent centralized market trading requirement under Core Principle 9 (the "85-percent requirement"). Under this requirement, a DCM would have to delist any futures or swap contract that failed to maintain a total volume of 85 percent on the DCM's centralized market. Total volume would be determined by reviewing the prior 12-month period of trading activity. Existing and new contracts would be subject to the 85-percent requirement.

I voted against this measure. Nothing in the CEA, as amended by the Dodd-Frank Act, requires that 85 percent, or any percentage for that matter, of trading in every contract listed for trading on a DCM to occur in a centralized market. I do not and will not support any rule that would force a DCM unnecessarily to delist futures and swaps, all of which are voluntarily cleared. In my view, this proposal was 100 percent MSU.

If this requirement were to become law as proposed, it would force hundreds of existing futures contracts to be delisted. Many of these contracts would either have to be unwound or converted into other derivatives and traded on a SEF. Market participants would generate significant tax liabilities, higher margin charges for financial products and entities would lose cross-margin efficiencies as a result of the 85-percent requirement. Not to mention, few, if any, swaps would continue to be executed on DCMs.

As I noted in my opening, centralized clearing has benefitted energy markets, but most, if not all, of energy contracts today would fail the 85 percent test. In addition, I am relatively confident that most participants would be entitled to the "end-user" exemption from clearing in the swaps markets. If clearing is a critical objective, then why in the world would we develop policies to drive people out of clearing for some arbitrary on-screen trading mandate, that doesn't exist?

The Commission contends that this proposal is necessary to "balance the goal of protecting the price discovery of trading in the centralized market . . . ."[23] In my view, there are several other ways the Commission could protect and increase price discovery. For example, the Commission could require DCMs to develop incentives to increase trading on a central limit order book or convert the 85-percent requirement into general guidance. Either of these alternatives would be an improvement over what the Commission proposed. Based on the comments received on the proposal, I am optimistic that the final rule will eighty-six the 85 percent.

Price Reporting Agencies: Is Survival Dependent upon Ubiquity?

As I noted in my opening, I would like to take a few moments to address the impact price reporting agencies have on futures, options and swaps markets. Without a doubt, these markets are closely intertwined. If we learned anything over the past decade it's that, when price

[23] 75 FR 80588.

reporting is based purely on an "honor system," honor has a price.[24] Of course, Mark Twain did say that, "Honesty is the best policy—when there is money in it." I thought it appropriate to address this issue here at the University of Houston, out of respect to an early thought leader on data reporting – Professor Craig Pirrong. It is also timely as the International Organization for Securities Commissions ("IOSCO") has released its recommendations on improving the functioning and oversight of price reporting agencies ("PRAs") in oil markets.

It was Professor Pirrong who can be credited for not only being at the forefront of the debate over price reporting, but for pioneering the concept of an "energy data-hub." This concept was the original Swap Data Repository (SDR), brought into existence by Dodd-Frank.

Last month, the G-20 tasked the IOSCO technical committee to prepare recommendations in collaboration with the IEF and the IEA and OPEC to improve the functioning and oversight of PRAs in the oil markets. The IOSCO consultation, "Functioning and Oversight of Oil Price Reporting Agencies"[25] (the "IOSCO Consultation"), builds upon a prior report on "Oil Price Reporting Agencies"[26] which was submitted to the G-20 in advance of the November 2011 Cannes Summit. The IOSCO Consultation examines to two factors:

- Governance of PRAs, including whether or not the PRAs have appropriate safeguards and procedures and whether or not independent oversight is needed; and

- Whether the PRA assessment techniques in physical and derivative markets are adequately transparent and the impacts that such assessment and data collection have on the markets.

IOSCO is seeking comment on the IOSCO Consultation, and this comment period expires next week. I would point out that, due to industry concerns, market participants can submit their comments anonymously.

PRA assessments and benchmarks are used to price transactions in physical markets, futures and other derivative markets. Not only in oil, but virtually all asset classes. What are we going to do about the currently listed 1,366 exchange-traded products that settle to a price index? What about the 829 of those products relating to the energy complex? I suppose the question I am really asking is, "What are you all going to do?" Professor Pirrong and UH-GEMI were at the forefront of the debate in 2003, and that is where you need to be now, in 2012. This time, the stakes are higher because we are dealing with PRAs on an international scale and there is a clear commitment to see this issue through to the end.

What Were We to Do?

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[24] Pirrong, Craig. "Been There, Done That." Streetwise Professor. Craig Pirrong. Jan. 29, 2008. Web. Mar. 12, 2012.
[25] *Functioning and Oversight of Oil Price Reporting Agencies, Consultation Report*, OICU-IOSCO, Mar. 2012, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD375.pdf.
[26] *Oil Price Reporting Agencies, Report by IEA, IEF, OPEC and IOSCO to G-20 Finance Ministers,* IOSCO, Oct. 2011, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD364.pdf.

Like I said, a decade ago, the energy sector was the Wild Wild West in terms of price reporting. There were a handful of major players and no one quite knew who was the sheriff and who was the outlaw, but then again, it was all a matter of perspective. The PRAs kept their operations in a virtual vault. Using their status as news gatherers, PRAs were able to shield themselves with the Constitution from both criticism and oversight. The CFTC enjoyed some victories in the D.C. District Court, most notably for finding that when it came to the Commission's pursuit of false reporting and manipulation charges designed to protect the public, the reporters' privilege as it applied to PRAs was qualified.[27] PRAs would, in some limited cases, have to respond to the Commission's data and information requests made in pursuit of misconduct under the CEA.

The CFTC was not interested in interfering with transactions in commodities like natural gas, but rather it was interested in the effects that other activities by market participants had on those transactions and commodity pricing in general.

It was the Federal Energy Regulatory Commission ("FERC") that took probably the most decisive step towards reigning in the indices. The FERC stepped in early and told the industry not to worry so long as they were reporting to the indices in good faith. FERC endorsed the CCRO's call to change middle and back-office practices to reduce the risk of traders lying to indices. Under threat of not allowing "tariffs" to refer to indices that did not comply with a set of best practices, FERC asked indices to improve how they collected data, to be less "editorial" in their "calculations", to engage third-party auditors for their processes, to promise to open books for investigations, and to publish information about the activity level behind every published price. This was a direct threat to PRAs because their participants were the same entities that were submitting to tariffs with FERC. If this sounds familiar, it is probably because it is consistent with Dodd-Frank's treatment of credit rating agencies.

Later on, FERC made price reporting mandatory for some classes of traders and eventually started collecting transaction information directly which was published with a lag. People could compare what activity levels PRAs said were captured in their indices against what activity FERC said actually happened. Now participants could evaluate, with a lag, if the level of underlying activity and PRAs' sampling of it gave them confidence the price index was meaningful.

Throughout this time period, other changes in the markets (including the growth of ICE and their pure transaction-based price indices), and additional high-profile manipulation cases brought by the CFTC and FERC reinforced the pressure on both market participants and PRAs to do the right thing.

"Unusually Powerful"

In July 2008, the New York Times ran a story about Platts' "boxing" of Lehman Brothers out of the Platts window, meaning that Platts would no longer take Lehman's bids, offers or deals into

[27] *See CFTC v. McGraw-Hill Companies, Inc.*, 390 F.Supp.2d 27 (D.C. 2005)

account in its assessment of end-of-day cash market prices.[28] While the "boxing" didn't prevent Lehman (whose credit condition was in question just months before its ultimate collapse) from trading in the market, it effectively ensured that the trades Lehman did engage in would not influence the end-of-day index price. Platts, the article noted, has neither the responsibility nor the resources to ascertain the creditworthiness of the companies who provide the deals that comprise the index, and yet it does intervene, potentially distorting the market. A former energy trader was quoted as inquiring, "Are they a reporting agency or a pricing platform? ... They can determine who can trade on their own system. This is unusually powerful."[29]

"A Benchmark to Fix"[30]

As I noted earlier, energy contracts make up a portion of the PRA products, but Platt's plays a major role. There are other PRAs out there that create critical financial benchmarks, including the most notable, the London Interbank Offered Rate ("LIBOR"). It is estimated that some $350 trillion in financial products utilize LIBOR as their benchmark rate. Professor Pirrong last week highlighted the relevance of LIBOR in a blog posting.[31] Suffice it to say, "Houston, we have a problem." In striking similarity to the issues raised with the energy PRAs post-CFMA, we've got seasoned market players—banks no less—feeding information to the LIBOR's publisher, the British Bankers' Association. The British Bankers' Association is not a regulator, and the contributor banks are not under its jurisdiction.[32] LIBOR is deeply embedded in hundreds of trillions of dollars' worth of financial contracts around the globe, some of which will endure for 20-30 years in the future. Clearly, this is a benchmark to fix.

The IOSCO Consultation

The general aim of the IOSCO Consultation is to understand whether the exchanges and market/industry participants (including traders, oil companies, refiners, and marketers) have concerns about the reliability of these indexes in light of their ubiquity and whether there are concerns regarding the possibility of manipulation. And, more broadly, what regulatory response is appropriate? The IOSCO Consultation requests comments on 31 questions covering such topics as: (i) the importance of PRAs in oil market functioning; (ii) the robustness of PRAs' methodologies; (iii) current standards of governance in PRAs compared to regulated financial entities; (iv) competition amongst PRAs; the role of PRAs in market development; and (v) options for oversight as to how PRA functioning might be improved and how public accountability could be introduced.

Recognizing that PRA-assessed benchmark oil prices are highly significant to the functioning of oil derivatives markets and the broader financial markets as well as the global economy, there are many participants in the physical oil markets, exchanges, clearing houses, and other derivatives

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[28] Luke Pachymuthu and Felicia Loo, Platts: Reporting Agency or Pricing Platform?, N.Y. Times, July 9, 2008, *available at* http://www.nytimes.com/2008/07/09/business/worldbusiness/09iht-col10.4.14366930.html
[29] *Id.*
[30] Financial Times, Global Interest Rates: LIBOR – A Benchmark to Fix, Financial Times, Mar. 12, 2012, available at http://www.ft.com/intl/cms/s/0/6e5d1d0e-694e-11e1-9618-00144feabdc0.html#axzz1pJ3coqRB.
[31] Pirrong, Craig. "LIBORGIGO." Streetwise Professor. Craig Pirrong. Mar. 14, 2012. Web. Mar. 16, 2012.
[32] Liam Vaughan, Gavin Finch and Jesse Westbrook, Life as LIBOR Traders Knew it Seen as Abusive by Investigators, Bloomberg, Mar. 2, 2012, *available at* http://www.bloomberg.com/news/2012-03-02/life-as-libor-traders-knew-it-seen-as-abusive-by-collusion-investigators.html.

markets that believe that PRAs are in the position to influence market development through changes they propose to benchmarks.

The More Things Change, the More They Stay the Same

The IOSCO Consultation asks some very hard questions about the large impact PRAs have on oil markets. Some of the reforms seem like overkill, but all deserve market input. I'd like to just highlight a handful of their concerns. First, ISOCO noted the methodologies utilized by PRAs show considerable variation. They run the gamut from almost entirely subjective to wholly mechanical. In spite of these variations, PRAs willingly publish their methodologies; but there remains a level of judgment as to their application. For example off-exchange transactions vary in terms with regard to volume, size, and quality of the crude, vessels, ports, and counterparty creditworthiness.

Second, market participants are not required to report to PRAs in general. Even when market participants do decide that it is in their interest to report and ensure that their transactions have a bearing on the PRA-determined benchmark price, PRAs do not contractually require participants to submit all of their transactions. Per the October 2011 report to the G-20, "The PRAs do not have the capability of auditing the completeness of the data they received."[33]

Third, IOSCO found that, "Amongst the PRAs, Platts prices are perceived to be firmly entrenched in the contractual fabric of the industry," and that its reporting methodologies influence the way the industry trades, especially with regard to the "Platts Window," whose resemblance to a trading platform is unquestionably subject to further examination.[34]

Finally—and this is the issue I am particularly interested in—since PRA benchmarks are widely referenced in such over-the-counter ("OTC") transactions, as well as ISDA master agreements, how do we ensure that the price discovery and influence of PRAs do not negatively impact our jurisdictional markets. More specifically, contract settlement and pricing details in a futures market contract, which references a physical or OTC benchmark, must not be susceptible to manipulation or gaming. We can't allow a market participant to impact the settlement of physical market pricing by gaming the futures markets.

While I do not think PRAs caused oil markets to recently cross the $100/barrel mark, given the interconnections between the physical and financial markets, the impact of that price reverberates across dozens if not hundreds of indices and benchmarks. And given what we know about PRAs, we need to be vigilant.

I strongly encourage you to review the IOSCO Consultation and provide critical feedback on its questions. You have about a week to review and respond. You've been given a unique opportunity, take it.

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[33] *Id* at 13.
[34] *Id.* at 4-5.

I also hope that I can continue to work with Professor Pirrong, the University of Houston and market participants to explore the best way to bring greater transparency to physical trade data worldwide and ensure that price discovery functions of the futures and swaps markets are not negatively impacted by reporting irregularities or weak or opaque methodologies of PRAs – not only in oil markets, but all jurisdictional markets.

Closing

Today I provided you a look at three specific topics the Commission is wrestling with. These issues only begin to scratch the surface of the broad regulatory reforms being considered by the Commission. As I noted, we still have over 20 rules to finalize, including a controversial entity definition, critically important capital and margin rules, definition of SEFs and, last, but not least, the definition of a swap.

The Commission will also consider changes to our market oversight in light of the MF Global bankruptcy.

Our challenge remains to pull together dozens of separate rules and ensure that they all work together in a cost-effective and cohesive manner. As I noted in my comments about cost-benefit analysis, I fear we are ignoring the very likely outcome of imposing higher costs on commercial firms across the country that had little or nothing to do with the financial meltdown on Wall Street. We must also resist the temptation to develop rules that attempt to fix a problem that does not exist, as I noted with Core Principle 9.

I appreciate the opportunity to speak with you and I hope you will provide useful recommendations to IOSCO and to me. Clearly traders and hedgers use physical, futures and OTC markets interchangeably to manage risk and discover prices. We must ensure these markets are transparent and not susceptible to manipulation. I hope you can provide your thoughts on possible remedies.

Finally, let me thank Professor Pirrong for his hospitality and for organizing such a great event.