SPEECHES & TESTIMONY

"Space Between Walls"

Speech by Commissioner Bart Chilton to the Finance, Credit and International Business Association International Credit Executives Conference, Chicago, IL

May 3, 2012

Introduction

Thanks to Rick Hayes for that great introduction. Aside from Russian roulette, having a fraternity brother introduce you must be one of the riskiest things that can be done. It really is wonderful to be with you this morning and be in my favorite city in the world: Chicago. I grew up in a lakefront neighborhood. On clear nights, you could see the Chicago skyline. I did not know, nor would have cared at the time, about the tremendous revolution, innovation and economic transformation of financial markets that was taking place in Chicago back then.

There is a fascinating new book written by the "father of financial futures" Dr. Richard Sandor entitled, *Good Derivatives*. The book chronicles the multitude of market innovations taking place since the 1970's, and the environment in which those innovations thrived. One key point Dr. Sandor makes is that in order to flourish, market innovations need proper regulation. One might say: there needs to be suitable regulatory walls and space between those walls that balances the public interest with the ability for the private sector to successfully innovate.

Impacts on Businesses and Economies

So today, let's do some discourse on the future of these spectacular global financial markets. Just think about the complex financing and credit, the capital and other resources—both human and technological—that all work in concert to facilitate these incredibly elaborate, intricate and inter-related global markets of colossal size and scope—churning, all day.

It truly is astonishing that it all works so well. But then again, we recognize there have been, and remain…well, issues. You know, like the t-shirt slogan, “I have issues.” Markets also have issues and they, more than anyone would like, do bizarre things. Or, the financial players don't do what they are supposed to do. Maybe regulators don’t do what they are supposed to be doing. Perhaps, available credit and balance sheets don't match up. How about technology? Sometimes, technology doesn't work like we thought it woulda, coulda, or shoulda.

We only need to consider 2008 and the commencement of the crisis—a crappy crisis for which the impacts are still being felt by businesses, economies and consumers. We are still, right now, today, dealing with that calamity and trying to recover. We will discuss the recovery more, but because it can help set the stage for where we are going, let’s take a quick trip back. I’m not talking about any time travel in Mr. Peabody’s WABAC machine. Anyone? Beuller? By the way, Disney is making an animated feature film of *Mister Peabody and Sherman* due out in 2014. Nope we just have to go back a few years to the Financial Crisis Inquiry Commission. FCIC was established to examine what took place in 2008 and why. FCIC determined that there were two culprits to the calamity—my phrase, not FCIC's.

- One culprit: regulators and regulation (you know, like me: we are from the government, and are here to help…oops). FCIC said that it was regulators and regulations because, in 1999, Congress and the president deregulated banks. Banks were no longer bound by that constrictive structure, the Depression-era Glass-Steagall Act that limited what they could do with the money in their institutions. With the repeal of Glass-Steagall, regulators got the message to let the free markets roll. They put a “do not disturb” sign on their door and said, "Move along folks, nothing to see here." The markets did rock and roll. Problem was: they did so to such a degree, they rocked and then rolled right over the American people.

- The second culprit to the calamity: The captains of Wall Street. FCIC concluded that since they were allowed to do so much more without those constrictive structures, the rules and regulations, the banks had a vast amount of "wide open spaces" in which to operate. They devised all sorts of creative, exotic and complex financial products. Some of these things were so multifaceted, hardly anyone knew what was going on or how to place a value upon them. What was the risk exposure? How much credit would such a trade require? Was it okay if one party to the trade valued the transaction at "a" while the other valued it at, not "b" but at "s" or even "z"? Like the Dixie Chicks sing, "She needs wide open spaces, room to make her big mistakes." Well, as the ole D.C. dodge expression goes, "mistakes were made."

Take Credit Default Swaps (CDSs)…please. Just jesting, but these highflying bets upon bets that certain things—say bundles of home mortgages—would actually nose-dive, were new-fangled products fashioned in the wide open spaces made possible by the repeal of the Glass-Steagall Act. CDSs were a major part and parcel that helped establish the trajectory for impending economic meltdown. I'm not suggesting all CDSs were or are wicked evil, of course not. I appreciate there are many that had and have a legitimate and valuable function. But just like candy to a baby, too much of a good thing can create major problemos, and that is what we saw take place with utterly unregulated CDSs. Countless CDSs took on a circuitous magical mystery tour hyperspace lifecycle of their own. They were traded and re-traded throughout the commercial cosmos. They were packaged and re-packaged, and valued and re-valued around the Street to the point that few understood what the things were, much less how to place a sound value upon them. In fact, the worth of CDSs was to a large extent in the eye of the beholder. If a firm needed the value to be such and such or this or that, they could make it so upon their balance sheet. Make it so, Number One. And, they did—aye aye, Sir. Just think about Lehman Brothers. In the final statement before they croaked, they held $691 billion in assets divided by only $22 billion in shareholder equity. These guys were leveraged at 30 to 1 for gosh sakes!

By the way, we now have a proposal that would require swap dealers and major swap participants to give their counterparties their valuation of a swap and then to resolve any material discrepancy between their valuation and their counterparty's before it becomes a big problem.

So, yes, CDSs were a significant component in constructing this ginormously humongous dark market with no oversight by regulators. When I say ginormously humongous, that's a technical term. You see, we at the CFTC currently oversee approximately $5 trillion in annualized trading on regulated exchanges, but the global over-the-counter (OTC) market is roughly—here it comes…coming to get you—$708 trillion. If you Google ginormously humongous, it should say, "See OTC markets."

There's an old saying in Washington that when Congress feels the heat, it sees the light. And that is exactly what happened in 2010 when Congress passed and President Obama signed into law the Wall Street Reform and Consumer Protection Act—otherwise known as Dodd-Frank.

The most important thing the law brings to markets is transparency. That $700 trillion-plus over-the-counter market has operated in the dark, without regulatory walls or light—but no more. Thankfully, that is all coming to an end.

Dodd-Frank has over 300 provisions requiring rulemakings—count 'em—I dare you. We have all seen some of the talking heads on TV say that it's too much regulation. There are way too many rules. But I think the glass is half-full, that this environment, like the environment Dr. Sandor discusses, brings about tremendous opportunity for innovation that can once again fuel-inject the economic engine of our democracy.

The Space Within

The great philosopher Lao Tzu, who is considered the father of Taoism, once said, "The reality of the building does not consist of the roof and walls, but the space within to be lived." He also said, "It is not the clay the potter throws that gives the jar its usefulness, but the space within." This is the same concept we have been discussing. The question arises: What is the correct regulatory structure? It is clear that no or little structure, like we saw in the lead up to the meltdown, wasn't appropriate. Will all those 300 Dodd-Frank regulations be the right blueprint for our regulatory structure? Did Congress over-reach and go too far the other way? Are regulators going too far?

Yes, in financial markets we need walls and a roof. We need the clay. Let's think of that as the regulatory environment. In the lead-up to 2008, the clay was pretty soggy—the regulations pretty soft. The roof leaked until the walls, as John Mellencamp croons, came tumblin' and crumblin' down. We had a financial disaster because nobody could see—least of all us regulators—what was going on in that space within. To some extent, Wall Street in the OTC space was more like a credit casino than anything else.

Well, the walls came tumblin' and crumblin' down for not only Lehman Brothers, but months before we saw Bear Stearns tank. I don't have too much sympathy for those folks, but I have a lot for the American taxpayer who was saddled with a repugnant relief effort known as the Troubled Asset Relief Program, or TARP for short. In total, $414 billion was allocated. Of that, $74 billion remains outstanding. As the FCIC said, the captains of Wall Street had their own playground and the regulators walked by without ever seeing anything amiss.

I contend that Dodd-Frank struck the right balance on the regulatory structure. It remains to be seen if regulators themselves will build appropriate internal walls and leave enough space within the walls. I believe we will. What has been done so far, by and large, has been pretty respectable and very substantial. At the CFTC, we have completed 31 of the roughly 50-plus rules, and we have not done them on a clock. We have not hurried them, but taken tens of thousands of comments and worked to get them correct. What has been done so far leaves a lot of room for genuine innovation and real creativity, real competition and real opportunities for economic progress.

There is even more room for innovation in the things that we will do in the next few months. Here are just a few: 1. Dodd-Frank told us to ensure that all products that could be cleared were cleared. There is a lot of room in the clearing arena for innovation and competition, for new or expanding businesses. 2. The law also instructed us to ensure that products are, to the greatest extent possible, traded either on an exchange or on what are called Swaps Execution Facilities or SEFs. I'm not sure how many SEFs will exist, but there will be a handful for sure and perhaps many. They will provide transparency and make for safer markets. They will compete. They will be individual economic engines for our financial markets and our economy. 3. There will be warehouses for all of the swaps data in the form of Swaps Data Repositories or SDRs. Here again, these are new businesses that will help provide transparency and safeguard markets while generating economic value for markets and economies; and 4. Think about the technological innovation—both software and hardware and the people in the private and public sectors who work on both—that will go along with all of these new systems and products and businesses. There is a mansion-load of space between the walls and a genuine opportunity for a great global financial future.

Roaming Regulatory Regimes

In 2009, in Pittsburgh, the G-20 met and agreed that they would all work to clear any trade that could be traded and to move as many trades as possible to either exchanges or other trading platforms and that the reforms should be completed by the end of this year. I'm not sure all of the G-20 nations can make that deadline, but we have seen sure-footed progress in the U.S., Japan and in the European Union (E.U.). The G-20 meets again in Los Cabos in June, and we will see if they alter the goal timetables, but either way, nations need to do their honest best to comply with the agreement. Of course, some nations won't move as quickly as others.

In this age of global financial markets, effective reforms cannot be accomplished by one nation alone. They will require a comprehensive, international response. If we don't do this together or at least in the same vein, we run the risk of regulatory arbitrage. I'm not suggesting that the E.U. or Canada or Japan or Singapore or Brazil or Hong Kong have to do precisely what the U.S. does. We all have sovereign issues, and we have diverse markets, let alone different interests that we all need to consider. However, we also have a lot in common. We all want to guard against systemic risks that can result in an impact on our national, regional or our world economy. As we know, we are all linked in today's world and one economy has an impact upon another. So, to the extent that we can approximate harmonization, we will be better off individually and collectively. We shouldn't open the door for regulatory arbitrage or trading migration to nations with the thinnest of rulebooks. Solid, but appropriate, regulation globally will lead to greater confidence and greater opportunities for consumers, businesses, markets, and economies. To the extent practical, reforms need to be developed and implemented in an interdependent and interactive fashion. I'm convinced that global financial regulatory reforms will take place eventually. It is certainly my hope that this takes place sooner rather than later.

Ponzimonium Poster Puke

While we are not finished in the U.S., we've come a long way on the regulatory front since the dark days of 2008 and beyond. At this point, though, let's discuss something that doesn't require additional regulations. What? Chilton's not saying "give me more?" No and here's why. Something additional happened in the space within during that period when the clay was soggy and the roof leaked. I can describe it in two words: Bernie Madoff. Ole Bernie traded in his Manhattan penthouse for a cell in the big house, but not before he ripped off billions-of-dollars from innocent folks in the biggest Ponzi scam in history.

You see, when the markets and the economy are spiraling down, some people pull money from investments just to live on. Others just don't want to lose more money, so they pull it out and put it someplace else—like under their mattress, perhaps. In the Madoff case, though, and hundreds of others like it, the money just wasn't there: kaput.

But that's over now, right? Bernie, the Ponzimonium poster puke, is in jail and nobody would dare try to pull that crap again. There's no space within where such schemes can exist anymore, right? Not so fast. Even though Bernie's was the biggest, there are many mini-Madoff Ponzi scams going on all the time. Did you know that in fiscal year 2011, our agency investigated more Ponzi schemes than at any time in history? So did other regulators. The FBI had more than 1,000 such inquiries. The Securities and Exchange Commission sees these things all the time, too. Unfortunately, we at the CFTC haven't seen any dramatic drop in cases this year. So, it's still Ponzimonium out there.

In that regard, I've tried to bring more attention to these scams. We released a book about some of them in November: *Ponzimonium—How Scam Artists are Ripping Off America.* Let me say loudly and clearly: this is a government publication and neither I, nor the CFTC, receive any money from the sale. I understand that some of you are getting copies of it today. That's great.

Ponzimonium tells the tales of ten such Ponzi scams that took place in 2009, in the wake of Madoff. They are real cases, real fraudsters, with unfortunately, very real victims.

It is amazing what these jerks did with other peoples' money. One con artist purchased a fleet of luxury vehicles including multiple Ferraris, Lamborghinis, Porsches, a Bentley, a Maserati, a Lincoln Limousine, and a metallic burnt orange Hummer golf cart. That guy took hard-working peoples' money and used it for a mansion, nearly 20 plasma televisions, sports and rock and roll memorabilia, and a contingent of body guards. Another fraudster bought a 269-acre ranch, a fleet of classic sports cars, two airplanes and massive diamonds for ladies he was wooing in New York, Toronto and St. Louis.

Many of the fraudsters are preying upon people through the use of "affinity fraud," where they use personal contacts to swindle family, friends, coworkers or even fellow church parishioners. One crook in the book, Marvin Cooper, is deaf. So, you guessed it, his victims were deaf people.

Just last week, the media covered one of these Ponzi cases where a guy in California who ran SNC Asset Management ripped off 500 individuals to the tune of $85 million in a scurrilous swindle. The whole nine yards: bogus statements, paying older customers/victims with newer peoples' money, and using the ill-gotten funds for his personal luxuries. Fortunately, the guy is damned to a dungeon for 15 years. Maybe it is just a penitentiary, but that's little comfort to those that lost money and may never get it back. The consequences for the investors-turned-victims can be decisively dreadful—people losing dough for their kids' college funds, for necessary health care expenditures, or for their own retirement. Some lose their complete life savings, and others participate for family members, acting as a custodian, thinking they are doing them a courtesy. It is an incredible shame because in almost every instance, these things were avoidable with a little education and some due diligence fact checking.

The book is being used as a supplemental text at Georgetown and American University, at the New York Law School and at the University of Chicago. But we need to get it to more people and financial literacy needs to be a national priority.

It amazed me to learn last week in a front page story in *USA Today* that only 13 states even require any personal finance class in high school. With little or no financial education about credit or banking accounts, let alone about financial markets, it isn't (I guess) a surprise that only 40 percent of 18 to 34-year-olds even have a personal budget. So, the average student loan debt alone is $25,000 (class of 2010), and for twenty-somethings, they have an average overall debt of roughly $45,000. Having that much debt, with no budget, while at the same time having to deal with an unemployment rate of 12.4 percent, as opposed to the national average of 8.2 percent, makes life for those that have had little financial literacy fairly difficult. But, even more than that, it impacts all of us by creating a less competitive work force. Those with higher rates of financial literacy get higher-paying jobs; they help themselves and their families; they help our economy and they help the country. We need to do a better job of ensuring that financial literacy is a priority. And, like I said, we can do that with not one more law, rule or regulation.

A Wilde Ride

It has been a pretty wild ride since 2008. But I'm very optimistic about the progress that has been made. I see great opportunities in our financial markets, from having more financially literate consumers (especially those who read the book) to having a more transparent and competitive marketplace full of new and never-before-built businesses.

Oscar Wilde—remember him, the long-haired cultural commentator from the late 1800s? I love one of his quotes. He said: "To expect the unexpected shows a thoroughly modern intellect."

In the late 1800's, perhaps his idea of modernity was a bit different from ours. Back then, people rode around in buggies, houses didn't have electricity, and their idea of indoor plumbing was, well, a pail.

But Wilde was clever enough to predict, in a general way, that modernity was coming.

The first plastic was made in 1862—and we all thought it was relatively new when *The Graduate* was released. Nope—it had been around about 100 years by that time. Typewriters, airbrakes, metal detectors, escalators, contact lenses, radars, dishwashers, washing machines, cash registers, seismographs, rayon and tungsten steel—all invented in the last half of the 19th century.

Isn't that amazing, all that innovation and invention? Think about what it must have been like to live back then, when the Industrial Revolution was leading people to ask, "Wha, wha, what?" And, these changes were felt not only by the rich and advantaged, but also by regular people. It was just at this time that Wilde made his observation to expect the unexpected—and all of these things were certainly "unexpected"—indicating a modern intellect. It must have been incredibly exciting, and a time when to have a "modern intellect" meant to be open not only to exciting new inventions, but also—almost by definition—to new ways of thinking.

Here's the point, and I do have one: We are in the midst of an equally mind-blowing phase, right now, in the financial world. The space within the walls is going to be bursting with new players, new exchanges and things we hadn't even contemplated. It reminds me of the Wilde ride of the 1880s in that way.

The Economy

Plus, the economy is on the right track. That's exciting, too. Unemployment is consistently ticking downward. We have seen consistent job growth with 4.1 million jobs created in the past 25 months. Consumer spending is up, and we have seen the biggest gain in home building in two years. Cars sold at their fastest clip in four years. Last Friday, we learned that the Gross Domestic Product (GDP) is trending very positive. We have seen 11 consecutive months of economic growth.

Think about where we were. In the final quarter of 2008 when those walls were tumblin' crumblin' down, the GDP was NEGATIVE 8.9 percent. What a gargantuan train wreck! That was the second worst quarter ever recorded. The worst quarter, by the way, was back in 1958 when GDP reached a negative 10.4 percent. Quarterly GDPs were not tracked during the Depression, but the worst overall year for GDP was 1932 at a negative 13.1 percent. The average GDP since 1946 has been 3.2 percent, so negative 8.9 in Q4 of '08 was extensively horrific. While the GDP for Q1 of this year slowed to 2.2 (it was 3.0 at the end of 2011), most economists still see this as a sustainable recovery. Gone is the talk about a double-dip recession. There is still positive and consecutive economic growth.

Conclusion

So, I'm very optimistic about the economy, about what we can do on financial literacy and what can be done on the regulatory front if we allow for the proper space between walls and we believe, like Oscar Wilde, and expect the unexpected.

Thanks so much for your time and attention. With the title of this speech being "Space Between Walls," I was tempted to hum or sing a little Dave Matthews' *The Space Between.* Actually, I'm still tempted, but I sound more like Governor Romney and less like President Obama, so I'd better spare you, and conclude. In fact, I'm more interested in what you have to say anyway—good, bad or indifferent—about what's going on. That's how I learn. So, as time permits before the next speaker, I'll be happy to take some questions or comments in "The space between what's wrong and right, is where you'll find me hiding, waiting for you."

Sorry, I couldn't resist. Don't tell. Thanks again.

Last Updated: May 3, 2012