Leading a Regulatory Agency

Lessons from the CFTC

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Every modern president has attempted to manage the regulatory burden that the federal government imposes on the private sector. Despite these attempts, the burden on American businesses and consumers continues to escalate. During the Reagan era, when the commitment to deregulation was strongest, regulatory creep still occurred at many agencies. Under President Bush, there were both some very active regulatory agencies taking advantage of a weakened Office of Management and Budget (OMB) and a strong Office of the Vice President that stemmed some of their worst excesses. The Clinton administration appears to be following the Bush model with one major difference—in the Bush administration the vice president's office provided a check on burdensome regulation while in the Clinton administration it appears more inclined to be a spur.

The sheer size and scope of the modern federal government makes the central management of regulation increasingly difficult. As a result, individual agency heads and their key policy personnel have greater power to influence the regulatory program of the agency—both positively and negatively. An activist agency head can undermine even an administration committed to reducing regulation. But a conservative agency head, with determined effort, can limit the growth of regulation.

Controlling regulation at the agency level, however, requires more than performing tasks more efficiently or managing well. It demands total commitment to addressing what we refer to as the "regulatory challenge," a challenge consisting of preventing the creation of bad law and policy, implementing statutes without stifling innovation or imposing unnecessary costs or burdens on the private sector, and providing legal certainty where needed.

The regulatory challenge, which is present in

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all agencies, exists for several reasons. Rules and regulations inevitably lag behind innovations in the private sector. As markets change, existing regulations become obsolete and require elimination or updating. Yet the incentives inherent in a bureaucracy make change difficult. Risk-averse regulators tend to resist comprehensive reforms.

Regulatory agencies also face tremendous pressure for increased regulation, pressure that can overwhelm those who lack a serious commitment to minimalist regulatory policy. Congress is often a source of pro-regulatory pressure, periodically attempting to micromanage agencies for political purposes. Pressure also comes from the regulated industry itself, as industry members seek special favors. And, of course, the news media fuels pressure for regulation, especially when it focuses on some problem out of context.

In this article, we describe the steps we took to meet the regulatory challenge at the Commodity Futures Trading Commission (CFTC). These initiatives, which were often in direct conflict with the natural predilections of much of the staff, were aimed at producing efficient regulations, deregulating where appropriate, bringing sound cases, curbing overreaching enforcement actions, and providing legal certainty to markets, even if that meant limiting the agency's authority or discretion. Many of the initiatives we discuss could improve the performance of most regulatory agencies. And the insights we offer into workings of a regulatory agency may help both current and future government officials interested in how to run a government agency, as well as business executives interested in how those agencies operate.

We readily recognize that the steps described here will not ensure that an agency will meet its regulatory challenge. It may well be that other measures are needed to shatter the iron triangle between regulators, special interest groups and members of Congress, and to alter fundamentally and permanently agency behavior and incentives. Until that day arrives, however, individuals can make a difference and affect an agency's regulatory record, at least in the short term.

An Overview of the CFTC

The CFTC serves as the exclusive overseer of futures and commodity option market regulation. The agency's mission is to ensure the financial and market integrity of the nation's futures markets by encouraging their competitiveness and efficiency, and by protecting market participants against fraud, manipulation, and abusive trade practices. Theoretically at least, this oversight enables the markets to perform better their primary economic functions of price discovery and risk management.

The CFTC consists of five politically appointed commissioners serving staggered five-year terms, with no more than three commissioners belonging to the same political party. One commissioner is designated by the president with the consent of the Senate to serve as chairman. This configuration, which contrasts with agencies that are headed by a single administrator, creates interesting dynamics. In an independent agency, major decisions cannot be taken without the agreement of a majority of the commissioners, at least some of whom may have been appointed by a different president. Another

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characteristic of many independent agencies is that they perform both rule-making and adjudicatory functions, including the use of agency administrative law judges. Thus, decisions may not be subject to independent judicial oversight.

The major operating programs of the CFTC are conducted through the General Counsel's Office, the Executive Director's Office, and the Divisions of Economic Analysis, Trading and Markets, and Enforcement. The Division of Economic Analysis conducts programs of market surveillance, new contract approval, and research. Trading and Markets oversees the compliance activities of the futures exchanges, monitors trades of floor traders and brokers, oversees the registration of industry professionals, and does financial and sales practice audits of registrants. The Division of Enforcement investigates and prosecutes alleged violations of the Commodity Exchange Act (CEA) and the

CFTC's own regulations. The general counsel is the CFTC's legal advisor, represents it in court, and drafts legal opinions to help the Commission perform its adjudicatory functions. The executive director provides administrative service support, including personnel matters, budget management, and information resource management.

The CFTC is easier to run than many other agencies because its iron triangle has not fully "solidified". First, the agency is relatively young. This means that the staff is not as deeply entrenched as those of other regulatory agencies

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and thus is not as reluctant to consider new ideas or different procedures. And the agency is relatively small, with between 550-600 employees during our tenure. This made it easier to spell out policy decisions to the lower ranks, and allowed more information to flow from them to the decision-makers at the top. Further, the professional staff is diverse and includes a fair mix of attorneys, accountants, and economists. Even the commissioners have a diverse background. During our tenure the Commission always included one member with an agricultural background, and at least two Ph.D. economists and one attorney. This mix, both at the staff and commissioner levels, helped bring a somewhat more balanced perspective on issues.

A second reason why the iron triangle is not as strong for the CFTC is that congressional oversight of the agency is the responsibility of the Senate and House agriculture committees. Because of this, the CFTC has not suffered from congressional micromanagement as much as other agencies. Members of these committees are generally interested in programs reflecting the agricultural interests of their home state constituents. However, the primary growth in the markets regulated by the CFTC is in the financial products markets. Because of this, the committees tend to pay less attention to the agency. Of course, the down side is that they tend to understand less about the industry and the markets that the CFTC regulates.

The third leg of the iron triangle, the regulated industry, has remained fragmented. The two dominant exchanges, the Chicago Board of Trade (CBT) and the Chicago Mercantile Exchange (CME), traditionally have been fierce competitors and often disagree with each other, if not on substance, at least on tactics. And while in recent years the CBT and CME have united on some issues, the futures commission merchants (FCMs) and the managed funds segments of the industry have gained stature and do not always agree with the exchanges. Thus, the industry is generally not united or dominated by one segment, making it more difficult for rent-seekers to capture the agency.

Another factor that provides a check on excessive regulation is the international nature of the industry. Foreign markets have experienced such dramatic growth in both numbers and volume that they now enjoy a market share roughly equal to the domestic industry's. These markets also offer comparable products and alternative regulatory schemes. Furthermore, advances in communication and information technology allow transactions to occur anywhere in the world. These developments help to limit the harm that U.S. regulators can do in at least two ways: First, businesses may go offshore to escape burdensome regulation; second, the increase in international competition causes regulators to consider their decisions more carefully.

Troubling Signs

When the new chairman, Wendy Gramm, arrived in early 1988, the CFTC appeared to be a model agency for addressing the regulatory challenge. However, the stock market crash of October 1987 created a major crisis, causing policymakers and elements of the public to call for market reform and increased regulation. Shortly, the CFTC would also face other market crises not entirely under its control. These crises would also cause increased pressure for regulation. Furthermore, there were indications that the iron triangle was solidifying , a development that would soon threaten to stifle innovation in the fast-growing derivatives industry. And the rapid changes in the market were producing two

effects. First, many regulations were becoming outdated. And second, as innovation and the use of derivatives grew, the staff indulged its bureaucratic tendencies by attempting to expand its jurisdiction and power to cover innovative derivatives such as over-the-counter (OTC) swaps and hybrids. This caused a great deal of legal uncertainty.

In early 1988, the agency was struggling with the aftermath of the October 1987 crash. Many blamed the crash on trading in the futures market and sought to ban or regulate this market more extensively. Most of the regulatory proposals put forth by politicians and pundits reflected ignorance of financial markets in general and derivatives in particular. The agency managed to head off potentially damaging proposals such as banning futures, limiting index arbitrage, banning computerized trading, establishing "cooling-off" periods, such as coordinating trading halts and suspensions, and shifting the regulation of stock index futures to the Securities and Exchange Commission (SEC).

Two other crises in the following year also had serious implications for the CFTC, creating the potential for bad law and policy. The first was the revelation of an undercover "sting" operation on the floors of the Chicago futures exchanges. This operation, engineered by the Justice Department and the FBI, sought to expose potential criminal violations of trading rules. Shortly thereafter, aggressive trading of soybeans by a large processor led to an emergency action by the CBT, which in turn generated significant complaints by farmers and Congress.

These crises sparked congressional interest in micromanaging the CFTC. Because of heightened public and press attention on futures market regulation, the agricultural committees and the other financial market oversight committees began to apply pressure for greater regulation. In addition, the Securities and Exchange Commission used the crises as an occasion to indulge in its periodic pastime of attempting to absorb some of the CFTC's jurisdiction.

While relatively young, the CFTC was beginning to show the classical life cycle symptoms of a bureaucracy. The staff was becoming increasingly entrenched, with many individuals having spent a large portion of their professional careers with the agency. Furthermore, only a very small proportion of the staff had had significant experience in the private sector. For these reasons, the staff had little direct experience in and knowledge of the explosion of innovative activity and new instruments that the derivatives industry was creating.

The CFTC's staff's response to market innovation was typically bureaucratic: it tried to prevent potential problems by stifling innovation. Thus, the agency's initial response was to question new products and trading systems and require increasing amounts of information from inventors, effectively slowing the introduction of new products. The staff also began to increase its jurisdiction through broader definitions of its regulatory domain; including a broader application of its definition of a futures contract.

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Notable indications of the staff's skittishness about new products were three related actions that would pose a serious threat to the rapidly growing off-exchange markets for swaps, that is, contracts between parties to exchange payment streams, such as fixed for floating rate payments in interest rate swaps, and hybrids, that is, securities or depository instruments having embedded commodity futures or option-like features. The agency's statute gave the CFTC exclusive jurisdiction over all futures activity and required all products thus deemed to be futures to be traded on an exchange regulated by the CFTC. In the first action, the Division of Enforcement investigated a major money center bank to determine whether the commodity swaps it offered were illegal off-exchange futures. News of this investigation caused much of the commodity swap business in the U.S. to halt or move offshore, and cast a shroud of uncertainty over the legality of the other swap markets for interest rates and currencies. In a second action, the CFTC sought and obtained through settlement a permanent injunction against Wells Fargo Bank in San Francisco, preventing it from offering a depository hybrid instrument with a return linked to commodity prices. These two events then led to a third, that is, the Commission issuing an "advance notice of pro-

posed rulemaking" that contemplated severely restrictive terms under which swaps and hybrids transactions could be conducted.

Outdated and Uncertain Regulation

The CFTC's regulations were outdated and reflected a market dominated by agricultural products with rules oriented towards the retail investor. However, the industry had changed to one dominated by financial products such as futures on Treasury bonds and Eurodollars. Furthermore, the industry was rapidly introducing many innovative, complex products that did not fit easily into traditional regulatory schemes. Accompanying these changes was a shift in market composition toward sophisticated institutional investors who required less regulatory protection.

For us, the regulatory challenge was to implement the CFTC statute without creating legal uncertainty, unnecessarily stifling innovation, or imposing excessive burdens on the regulated industry.

In addition, some aspects of the Commission's rulemaking processes were particularly troublesome. First, staff did not explicitly present cost-benefit analysis or discuss alternative methods for meeting regulatory objectives. Also, steps were needed to make the "no-action process" more visible to both the Commission and the general public. As is true at most agencies, much of the CFTC's law is developed in its no-action letters and other guidances, some of which may be communicated orally, and hence, referred to as "oral okey-dokeys". These serve as an important source of clarification for lawyers who advise or render formal opinions of the law to their clients. In many instances, however, these statements go unreviewed by the CFTC, and may actually conflict with its policy views, thus creating legal uncertainty. Increased visibility would also benefit those who did not have the resources to access the Commission directly. And by creating greater public access, the incidence of the staff's granting special rulings for favored groups or individuals would be reduced. Eliminating staff discretion would shift the process back from one of "rule of man" to one of "rule of law."

A related and potentially more serious problem are the "oral no-ways" that staff give to market participants. For example, Commission staff may tell an exchange not to submit certain proposals for approval, or assert that if certain proposals are submitted, they will not be approved. Such exercises of power may never come to the attention of the Commission for fear of retribution by an exchange.

Another area that demanded our attention was the CFTC's use of rule enforcement reviews (RER). An RER is a periodic review of an exchange's own oversight systems to see how well it is complying with procedures. Following a RER, the CFTC staff prepares a report with recommendations. The report and recommendations are made public, which serves as a strong incentive for the firm or exchange being audited to have a good report. No exchange wants the CFTC to say that its systems for finding and disciplining traders who abuse their customers are inadequate. Thus, the CFTC wields enormous power in these reports. The staff tends to qualify good findings and rarely gives an unequivocally positive report. Recommendations in RERs often become de facto mandates. An exchange's refusal to adopt a recommendation can give the appearance to the public or the congressional oversight committees that the CFTC is not committed to tough enforcement of its rules. The Commission can also require an exchange to adopt a recommendation. Sometimes the staff will get a smaller exchange to agree, and then impose the same requirement on the recalcitrant exchange. All of this amounts to rulemaking without complying with the Administrative Procedures Act (APA). That Act requires agencies to follow certain procedures, including seeking and considering public comment in the course of a rulemaking.

In sum, the CFTC was quickly becoming like many other regulatory agencies. As a first step, it was necessary to reform the CFTC's agenda. This required overcoming several obstacles. First, there were few policymakers outside of the agency who understood and were also willing to acknowledge publicly the value to the economy of derivatives markets and the role of risk-shifting instruments. And second, CFTC staff on the whole was not well-equipped to

understand the changes that were occurring in the market and the implications for the direction that policy should take.

What Was The Agenda?

For us, the regulatory challenge was to implement the CFTC statute without creating legal uncertainty, unnecessarily stifling innovation, or imposing excessive burdens on the regulated industry. We needed to insure that the regulatory scheme would not interfere with the dynamism of the commodities markets. At the same time, we needed to make certain that regulations and enforcement would provide the protections needed in an international market where trade and fraud can easily cross borders using new technologies.

We established three basic operating principles that would guide the agency during our tenure:.
(1) *Prevent the creation of bad law and policy*;
(2) *Ensure that all regulations, proposed and existing, are effective and efficient*; and
(3) *Enforce the law vigorously, yet appropriately*.

Many bad laws and policies have their roots in ignorance of market principles and misconceptions about the proper role of regulation. Thus, it is imperative that the vigilant agency head block any ill-conceived proposals before they can harm the market. This requires the assistance of talented and knowledgeable staff members who are adept at providing the appropriate information to policymakers and the public. Those of us on the Commission wanted to make sure that the appropriate organizations and user groups saw us as attentive and responsive to their concerns and inquiries. This is especially important in the event of a crisis, such as the stock market crash of 1987. All too often the old adage "one anecdote makes a regulation, two make a law" is true. Too many hastily conceived regulations and laws have worked to the detriment of the economy.

The second principle, "ensure that all regulations—proposed and existing, are effective and efficient," means that any new regulation should be targeted to address a specific issue, be efficient, and, when possible, rely on performance standards. As markets evolve, existing regulations should be reviewed so as not to impose unnecessary costs or burdens on the industry.

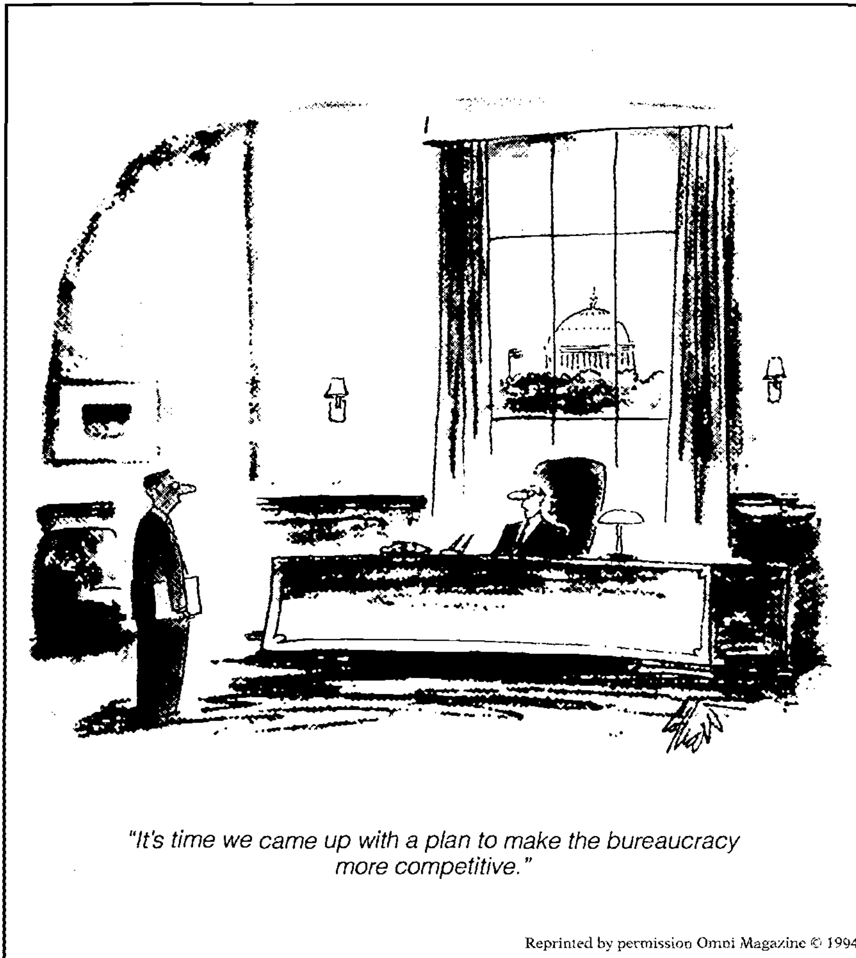
In practice, regulatory review is not easily accomplished. Agencies generally do not give priority to reviewing old rules since there are always many other issues to address. Bureaucratic inertia is also a problem. It is often difficult for staff members to admit that regulations they know well or helped draft are obsolete. Often, the industry itself lacks the incentive to push for the elimination of outmoded regulations. In these cases, the marginal cost of continuing to comply with the regulation is less onerous than the effort necessary to secure relief. For these reasons, in order to ensure regulatory flexibility, regulatory agencies themselves must develop systems for pruning obsolete regulations.

Staff members should focus on commonly recognized transgressions such as fraud, rather than cases that push the reaches of law. They should avoid regulation by prosecution.

An agency's intervention into markets extends beyond its regulations. Cost-benefit analysis should be applied to often overlooked, yet equally important "informal" or "non-rule" rulemakings. These include no-action and interpretive letters, guidances, orders and policy statements, rule enforcement reviews, litigation and enforcement cases, and adjudicatory opinions.

The first line of defense in "enforcing the law vigorously, yet appropriately," is to establish "bright lines" that enhance programs of deterrence and prevention. Market participants need to understand the law and the consequences of illegal behavior. Limited resources require regulatory agencies to give priority to prosecuting the most serious violations.

Staff members should focus on commonly recognized transgressions such as fraud, rather than cases that push the reaches of law. They should avoid regulation by prosecution. Finally, regulators should strive to avoid actions that could interfere with legitimate business activity. For example, cases should not be based on ex post facto analysis of representations. Neither should standards established in a case deter a risk-averse firm from engaging in beneficial activity.



"It's time we came up with a plan to make the bureaucracy more competitive."

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What Was Attempted?

We had a good deal of success implementing the principles discussed above. First, the agency was able to thwart most of the destructive policy proposals that were inspired by the October 1987 crash. One of the most important factors in preventing bad policy at this time was the Working Group on Financial Markets, an inter-agency committee made up of the heads of the CFTC, SEC, the Board of Governors of the Federal Reserve, and the Department of Treasury. Input from other financial market regulators was invaluable in helping us institutionalize our agency's ability to meet the regulatory challenge.

The Regulatory Coordination Advisory Committee's job was to create pressure to eliminate obsolete regulations and to help offset pro-regulatory pressure from Congress, the press, and others.

The CFTC also issued new rules and policy statements that clarified the boundaries to its jurisdiction, thus allowing innovative OTC products to develop. Other crises that followed shortly, especially the undercover "sting" operation, did have an impact on the CFTC's reauthorization bill. However, the agency managed to soften some of the bill's most dangerous provisions by inserting phrases such as "if practical" to ensure that subsequent regulations would be cost-effective.

Also, existing regulations were reviewed and many changed. With respect to enforcement, the CFTC focused on eliminating fraudulent sales operations. We also took care to ensure that the agency did not expand its jurisdiction or the law through enforcement cases.

In an attempt to institutionalize the agency's ability to meet the regulatory challenge, we initiated many reform projects; some were successful and others were not. The reforms fit into three broad categories: structural reforms, process reforms, and personnel reforms.

I. Structural Reform

Three important structural changes were proposed. Two were implemented with varying degrees of success and one was left incomplete.

Like many other agencies, the CFTC utilizes several advisory committees established according to the requirements of the Federal Advisory Committee Act. The advisory committees are an effective channel of communication between the

agency and the regulated industry. The most important structural change was the establishment of the Regulatory Coordination Advisory Committee (RCAC), an industry users' group chaired by the agency chairman. The RCAC consisted of high level executives from agriculture, the financial services industry, and the managed funds community. Its job was to create pressure to eliminate obsolete regulations and to help offset pro-regulatory pressure from Congress, the press, and others.

There were two reasons for the creation of this committee. First, agencies are often so busy dealing with the crisis of the moment that they do not have the time to work on changing outdated regulations or guidelines. Second, this group of users could provide practical expertise to augment the staff's knowledge of the latest market developments and regulatory innovations, including developments overseas. This could enable the agency to benchmark our practices against those of other regulators, both domestically and around the world. The RCAC could also identify how certain rules could be made consistent with those employed in other regulatory regimes, thus reducing the costs to users.

Staffers would tell each other, in effect, "don't interfere with my document, I won't mess with yours." The result was bureaucratic stagnation.

Key to the RCAC's success was meeting regularly and having the CFTC chairman head the committee. Not only did attendance remain high, but the members supplied substantive data to support their recommendations. The regularity of the meetings had the desired effect of keeping the chairman and staff focused on making sure that there would be progress to report at each meeting. Also, the advisory committee provided a public forum where the staff could and did receive numerous accolades for making changes important to the competitiveness of the industry.

The second important structural reform was our use of the inspector general's office. The Inspector General Act of 1978 gives the IG statutory authority to review regulatory and legislative proposals of an agency and to provide management analysis of agency programs. The director of the IG office for the CFTC had both law and economics degrees, which helped him better evaluate commodity futures cases.

We used the IG to evaluate various agency programs and processes. The IG also received a "sign-off" line on rules and testimony sent to the Commission. Some of the management projects the IG undertook included a review of recruiting and training practices and a study of the value of having staff conduct in-person floor surveillance at the exchanges. In general, the IG provided a valuable, independent evaluation of the costs and benefit of CFTC rules. His opinion added weight to the policy directives of the chairman.

A third structural initiative was a plan to reorganize the agency to make it more flexible and responsive to the realities of a dynamic international marketplace. The reorganization plan was approved by the Commission and OMB, but was not implemented because of the change in administration.

One aspect of the plan worth discussing shows how agency structure can make an important difference in the regulation of an industry. Almost all exchange procedures are in the form of exchange rules that require updating to keep pace with changing market conditions. Before an exchange rule can be adopted or changed, it must be reviewed by the Commission. The reorganization plan would have separated the unit that evaluates all exchange rule proposals (the "gardeners") from the control of the exchange oversight division (the "weeders") and created a small, separate division. The rationale was that the oversight staff charged with enforcing the law tended to be very risk-averse and reluctant to allow new procedures that might increase the potential for fraud. Thus, rules supporting new procedures could be delayed, changed, or sometimes killed before any policymaker could have input. Under the proposed plan, if an exchange rule to implement a new procedure was deemed adequate by the evaluation division, but met with disapproval by the oversight division, the conflict would be elevated to a policy level. This would have made it more difficult for exchange proposals to be killed without the knowledge of policymakers.

II. Special Projects

Regulations produced by an agency fall into three general categories: new rules, existing rules, and the less visible "non-rule" rules such as those effectively created through no-action letters, enforcement cases and RERs. We wanted to ensure that new rules were subjected to cost-benefit analysis, that systems were in place for the continuous review and justification of existing rules, and that the "non-rule" rules were consistent with the Commission's policies. Several changes in operating procedures were initiated and several special projects begun in an attempt to gain control of the agency's regulatory output. The first and most important change was the "no surprises" policy the chairman initiated. In order for the chairman to be fully knowledgeable about the various "rule-making" activities of the agency, all documents, including correspondence containing policy prescriptions, had to be reviewed by the chairman's office before release or circulation to the rest of the Commission.

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Many documents reflected bureaucratic territoriality that could produce inconsistent policy. Staffers would tell each other, in effect, "don't interfere with my document, I won't mess with yours." The result was bureaucratic stagnation, with documents remaining primarily the products of the originating division. We attempted to rectify this situation by providing early review by the chairman's office. Early review provided policy guidance to staff and enabled the chairman to obtain more input from lower level staff and experts in other divisions from experts in other divisions and lower level staff. Ensuring early policy guidance for all the agency's activities was a necessary first step in getting the agency moving in the direction set by the chairman.

To guarantee that all rules promulgated by the CFTC were necessary, efficient, and addressed a systemic problem, several actions were taken including: (1) broadening responsibility for rule writing; (2) employing more economists to evaluate costs, benefits, and alternatives; (3) expanding the role of the IG to include evaluating rules and legislative proposals; and (4) exposing the "non-rule" rules such as no-action letters to more sunlight.

The economists were asked for their input into enforcement actions, no-action letters, rule enforcement reviews, and rules and rule changes proposed by exchanges. They also performed studies of important policy issues. Their involvement in a broad array of issues and initiatives markedly improved both the analyses and the quality of documents.

As mentioned earlier, in the past, many no-action letters were sent to petitioners only and never made public. We initiated procedures whereby all no-action letters are published by the agency without identifying firm-sensitive information. These efforts to give the no-action letters more public visibility were codified into a rulemaking to make the procedure more permanent.

Each of these changes was effective in improving regulation. There were, however, limitations to their effectiveness. First, a future Commission could rescind these changes. Second, there are only so many documents a chairman's office can review. At many of the larger regulatory agencies, it would be nearly impossible to review all documents. Thus, one would have to rely on key personnel in middle-management positions to provide comparable review. Third, these changes would not be effective against some of the less visible rulemakings, for example, staff's granting of "oral okey-dokeys" or "oral no-ways." Finally, these changes did not address the issue of reviewing rules already in existence. In order to address this issue, we instituted the *Excellence 2000* project. One of the key features of this project entailed an evaluation of all existing regulations and programs, in order to identify and eliminate or change those which imposed unnecessary burdens. To assist the Commission in its review, the industry was invited to comment. As a result of this effort, dozens of regulations were

eliminated, producing substantial relief for the industry.

Any agency tends to have backlogs primarily because risk-averse staff takes too long or is too perfectionist with regard to decisions. Backlogs may be reduced by simply making more people aware of the amount of time a request has been at an agency. We established a tracking system that was accessible on the agency's computer network. This system tracked all exchange rules, petitions, and new contracts submitted to the agency and identified key staff assigned. The beauty of the tracking system was that it provided information to others throughout the agency. Thus an economist might see that a new rule had been proposed in an area of his or her interest and relevant expertise. Even if the staffer in charge may not be inclined to include others in the review process, the tracking system made broader input possible.

We also completed two projects aimed at reducing backlogs. The first initiative, "Operation Backlog," was aimed at reducing the number of cases on appeal. Before the project started, an administrative law judge's decision that was appealed to the Commission often took several years to be resolved. Often, one full year would elapse before the case was even assigned to a staff attorney. By getting "volunteer" help from commissioners' staffs and others in the Office of the General Counsel, the backlog was eliminated. This meant that as soon as a case was appealed, a staffer could be assigned to work on the case. Also, elimination of the backlog meant that current Commission positions and standards could be signaled to the market more quickly. In addition, elimination of the backlog had a positive psychological effect on staff, as they were more likely to work efficiently on newer cases.

Another highly successful project involved expediting the approval process for new contracts submitted by the exchanges. The CFTC is statutorily required to review each contract individually before granting approval. The exchanges and market users were extremely concerned about the time required to gain approval and the ability of U.S. exchanges to compete successfully with the foreign exchanges and the off-exchange market. A task force was created and assigned the mission of reducing the costs associated with preparing a submission and, more importantly, speeding up the approval process. The task force developed several recommendations, including a new set of guidelines that were adopted and published in the *Federal Register*. The changes facilitated the approval of a record number of new contracts for three years running, a two-thirds reduction in the average approval time, and a corresponding reduction in the fee charged to the exchanges for each new submission.

It is a truism that your people are your policies. If you want an agency to move in a specific direction, you must have key people who understand your goals, will help implement your changes, and will lead the agency in the direction you designate. This is especially important when meeting the regulatory challenge, since an administrator likely will be leading the agency in a direction many staffers do not want it to go.

Obviously, one method of ensuring that the agency's key personnel are committed to moving the agency in the right direction is to bring in your own team. A good example of this is the team that James Miller brought with him to the Federal Trade Commission in 1981, the beginning of his tenure as chairman, which included a chief of staff, legal and other assistants within his personal office, the heads of all the bureaus, comparable to the CFTC's "divisions," and even mid-level staff within the bureaus. However, this opportunity is not available in many instances because budgetary and personnel rule limitations prevent significant changes.

Future agency heads would be wise to make changes quickly, before becoming subsumed in managing or caught up in dealing with crises that inevitably arise.

At the CFTC, many of the senior staff positions were held by career employees. Initially, the chairman brought in only one key staffer, Robert Mackay, a chief of staff with a Ph.D. in economics who had significant expertise in financial markets and experience in government, including the CFTC. (Mackay is the co-author of the article on derivatives elsewhere in this issue.) Mackay was instrumental in the first year's efforts to prevent bad law and policy in the aftermath of the stock market crash and in the effort to move the agency away from the

direction it was heading with regulation of OTC derivatives. Over time, other senior staff were replaced with individuals who understood markets and shared the policy perspectives of the chairman.

Another important element in meeting the regulatory challenge was the appointment of a third Ph.D. economist as a commissioner. William Alberecht, working with the other commissioners, helped ensure that the agency was moving in the appropriate direction.

Agency heads should take care to fill vacancies with individuals who understand economics and are committed to meeting the agency's regulatory challenge. One of the key factors in our success was our hiring of economists. For entry-level jobs at CFTC, we obtained the services of several individuals who had attended top-rated doctoral programs in financial economics. Although starting government salaries were not competitive with those in academia, many welcomed the opportunity to work on important policy issues. Several talented professors were also brought in under short-term appointments, while others with specialized expertise came in under the Intergovernmental Personnel Act program. The presence of these individuals had the added benefit of raising the quality of work of the career economists. These individuals played crucial roles in developing several important rulemakings and studies.

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Communicating the agenda within the CFTC was another way to control policy. Special in-house courses, a series of brown bag luncheons hosted by the chairman, and an outside speaker series were among the means employed to this end.

Several in-depth training courses were brought to the agency. "Economics for Regulators" covered topics like hypothesis testing, cost-benefit analysis, economics of information, optimal penalties, and market microstructure. "New Financial Products/Off-Exchange" covered financial market innovations in the OTC market and methods of analyzing the new products. Other courses included "Plain English Writing of Legal Documents" and "Conflict Management and Resolution."

Further training was provided through brown-bag luncheons that provided the staff the opportunity to meet with the chairman in an informal setting. These luncheons can be a very effective means for bypassing middle management and communicating directly to staff the policy direction of the chairman. A speaker series was started featuring current and former leaders in government, industry and academia. This served to provide the staff additional exposure to individuals who could help explain and reinforce many of the chairman's objectives.

Career civil servants, including the highest level Senior Executive Service corps, have nearly unbreachable job security. Furthermore, the incentives they face often work against the public interest. They have little incentive to take risks, since doing so can result in severe and public punishment, while failures to take risks are barely noticed. Complaints by exchanges and firms whose requests have languished for months or even years often go unheeded by the press or Congress. Very often, industry complaints are suppressed for fear of retribution by staff.

We made attempts at the CFTC to change incentives by changing the criteria on which the staff were evaluated, paid, and otherwise rewarded through bonuses, awards, and other methods of recognition; for example, praising productive staff at public and advisory council meetings. Also, performance elements were changed to improve senior staff's incentives to take policy direction from the chairman and the Commission.

Many of these initiatives were extremely effective; however, in retrospect, we would have implemented some of them earlier and more aggressively. Examples include the reorganization plan, *Excellence 2000* and the chairman's brown bag lunches. In addition, efforts to reduce the bureaucracy by cutting staff should have been pursued more vigorously, including reduction by attrition.

Conclusion

We believe that we made a good deal of

progress during our tenure at the CFTC. We eliminated many burdensome regulations and streamlined some tangled and confusing processes. Under our leadership, battles were won that brought increased legal certainty, helping U.S. markets to maintain their world leadership in this field. The staff was broadly exposed to principles of sound regulation. These accomplishments suggest that committed individuals can make a difference, even in an administration that is not fully committed to controlling regulation.

Admittedly, the CFTC was easier to run than many agencies. And we are not so naive to believe that all of the gains were permanent—some have already been reversed. For example, there have been no meetings of the RCAC since the summer of 1993. Still, we believe that many of the reforms affecting personnel, structure, and processes can be applied to any agency looking for ways to improve regulation. Many of these valuable lessons took time to learn, while others were discovered late in our tenure. Future agency heads would be wise to make changes quickly, before becoming subsumed in managing or caught up in dealing with crises that inevitably arise.

Selected Readings

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