COMMODITY MARKETS OVERSIGHT COALITION

An Alliance of Commodity Derivatives End-Users and Consumers

May 1, 2013

The Honorable Debbie Stabenow
Chairwoman, Senate Committee on
Agriculture, Nutrition & Forestry
328A Russell Senate Office Building
Washington, DC 20510

The Honorable Thad Cochran
Ranking Member, Senate Committee on
Agriculture, Nutrition & Forestry
113 Dirksen Senate Office Building
Washington, DC 20510

Re: Input on Commodity Futures Trading Commission Reauthorization

Dear Chairwoman Stabenow and Ranking Member Cochran:

The undersigned organizations write in response to your March 7, 2013 request for recommendations regarding the reauthorization of the Commodity Futures Trading Commission (CFTC). We commend your commitment to an open and bipartisan reauthorization process and thank you for the opportunity to provide the input of our coalition, its constituent organizations and their members.

The Commodity Markets Oversight Coalition (CMOC) is a non-partisan alliance of organizations that represent commodity-dependent American industries, businesses, end-users and consumers. Our members rely on functional, transparent and competitive commodity derivatives markets as a hedging and price discovery tool. As a coalition, we favor government policies that promote stability and confidence in the commodities markets; seek to prevent fraud, manipulation and excessive speculation; and preserve the interests of *bona fide* hedgers and American consumers.

Background

The CFTC was last reauthorized through 2013 in the Food, Conservation and Energy Act of 2008, also known as the "2008 Farm Bill".[1] At the urging of our coalition and in response to dramatic changes in the marketplace, Congress expanded CFTC authority over the futures, options and swaps markets during its 2008 reauthorization. This included language from the bipartisan "Close the Enron Loophole Act" expanding oversight to "price discovery contracts" on previously unregulated electronic trading platforms.[2] The 2008 bill also strengthened antifraud provisions and increased civil monetary penalties for manipulation and attempted manipulation from $500,000 to $1 million per violation.

However, much of the deregulation of the derivatives markets under the Commodity Futures Modernization Act of 2000 (Pub.L.106-554) remained unaddressed until the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,[3] simply referred to as the "Dodd-Frank Act." Building on the reforms included in the 2008 Farm Bill, Congress used the Dodd-Frank Act as a means to further address the crisis of opacity, instability and diminished confidence in the derivatives markets and to address factors that lead to the 2007-2008 bubble in commodity prices.

Title VII of the Dodd-Frank Act included the most comprehensive reform of the Commodity Exchange Act (CEA) since the Great Depression. It expended CFTC oversight to over-the-counter (OTC) swaps markets and strengthened the CFTC's ability to conduct market surveillance and

[1] Pub.L.110-246

[2] The Close the Enron Loophole Act was introduced in the Senate (S.2058) by Sen. Carl Levin (D-MI) on September 17, 2007 and in the House (H.R.4066) by Rep. Peter Welch D-VT). The House bill had three Republican co-sponsors, including Reps. Chris Shays of Connecticut, Jeff Fortenberry of Nebraska and Todd Platts of Pennsylvania.

[3] Pub.L.111-203

prevent fraud, manipulation and excessive speculation in the commodity markets. This includes but is not limited to: new data reporting and registration requirements, clearing and trading requirements and price transparency for swaps, mandatory speculative position limits, prohibitions on disruptive trading, and expanded authority to prosecute fraud and manipulation. It is also important to note that Congress sought to preserve the interests of *bona fide* commercial hedgers by exempting them from potentially burdensome requirements meant only for speculative traders, financial institutions and systemically significant market participants, such as position limits and new margin requirements.

Since its inception in August of 2007, our coalition and its member organizations have delivered testimony and written Congressional leaders in support of these reforms. While the Dodd-Frank Act was indeed historic legislation, it was not perfect legislation and Title VII reforms are no exception. As members of the committee work to draft legislation to reauthorize the CFTC, we encourage you to consider inadequacies and inefficiencies in the Dodd-Frank Act and related rules and regulations, and changes in the markets since its enactment. All the while, the committee should be mindful of the need for stable, transparent and accountable futures, options and swaps markets and the effect on the confidence of consumers, commodity end-users, *bona fide* hedgers and other stakeholders.

We submit for your consideration the following issue areas that the committee should examine as it drafts a reauthorization bill. The CMOC would appreciate the opportunity to amend or expand upon this list of recommendations (if necessary) as the committee process continues. Also, these recommendations do not preclude the submission of supplemental recommendations by individual CMOC organizations or their members and affiliates.

Manipulation & Excessive Speculation

Speculative position limits are important in preserving the integrity of the commodity markets and the needs of *bona fide* hedgers. Such limits serve to prevent market manipulation (such as corners and squeezes) and unwarranted price swings associated with excessive speculation. Therefore, our coalition strongly supports the decision of Congress to mandate speculative position limits under Section 737 of the Dodd-Frank Act.

The CFTC approved a final rule establishing mandatory position limits on October 18, 2011. This rule was to go into effect on October 12, 2012. However, the rule was vacated by a District Court Judge on September 28, 2012 and the decision is currently under appeal. Our coalition strongly supports the immediate implementation of mandatory position limits and believes that the intent of the Congress was clear and unambiguous in this regard. On April 22, 2013, we filed an amicus curiae brief with the Court of Appeals and we are confident that the District Court's decision to vacate the position limits rule will be swiftly reversed.

Still, **the committee should examine the efficacy of the October 18, 2011 position limits rule in preventing market manipulation and the harmful effects of excessive speculation**. Specifically, members of our coalition have expressed concerns to regulators that individual position limits set forth by the rule are too high, and that the rule only requires periodic review of established limits (annually for agricultural contracts and biennially for energy contracts).[4]

In addition to individual speculative position limits as set forth by the rule, an effective way to prevent excessive speculation from distorting commodity prices and to restore the balance between commercial hedgers and financial investors is to require aggregate limits on all speculation as a class

[4] See comments by Delta Airlines, the Air Transport Association (now Airlines for America) and the Petroleum Marketers Association of America and New England Fuel Institute Comment letters on the Position Limits for Derivatives," 76 FR 4752 (Jan. 26, 2011), submitted to the CFTC on March 28, 2011.

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of trader. In the forthcoming CFTC Reauthorization Act, **the committee should expand upon the existing Dodd-Frank Act position limits mandate to require the CFTC to establish class-specific limits on speculation.**

Index Funds

Congress and the CFTC have yet to adequately address the well-documented harm caused by index fund speculation in the commodity markets. In June of 2009, the Senate Permanent Subcommittee for Investigation (PSI) published a bipartisan report by Chairman Carl Levin of Michigan and ranking Member Tom Coburn of Oklahoma entitled *Excessive Speculation in the Wheat Market.*[5] The report concludes that the "activities of commodity index traders, in the aggregate, constituted 'excessive speculation,'" and that index funds have caused "unwarranted price changes" and constitute an "unwarranted burden on commerce." The PSI report urged legislative and regulatory measures to limit the impact of index fund investments in commodities.

These recommendations include the phasing-out of CFTC no-action letters that essentially classified index funds as *bona fide* hedgers and exempted them from speculative position limits. The report also urges the CFTC to collect more data and evaluate the extent to which index funds affect prices for non-agricultural commodities including crude oil. While the CFTC has made considerable effort to improve data collection, regulators have not yet published any sort of comprehensive evaluation on the role index funds as recommended by the bipartisan PSI report. **The committee should inquire with the CFTC on its progress in implementing the recommendations of the bipartisan PSI staff report and addressing end-user concerns over index fund speculation.**

Of note, our coalition has supported legislation in Congress that would limit the ability of index funds to speculate in commodities. In the House of Representatives, Congressman Ed Markey of Massachusetts introduced the Halt Index Trading of Energy Commodities (HITEC) Act (H.R.785) on March 13, 2013. It currently enjoys 21 cosponsors. The bill would prohibit new investments in commodities by index funds and give existing index funds two years to wind down their positions. **The committee should consider proposals to limit the role of index funds in commodities for possible inclusion in the forthcoming CFTC Reauthorization Act.**

High-frequency Trading

In order for commodity prices to accurately reflect real-world supply and demand, futures, options and swaps markets must be driven by educated traders that are responding objectively to market fundamentals. Our coalition grows increasingly concerned over the impact of high-speed automated trading by means of computer algorithms - also known as algo-trading or High-frequency Trading (HFT) - on the commodities markets. HFT has already become a dominant force in the securities markets and many allege it has been responsible for a series of disruptive market events, including the flash-crash that caused the Dow Jones Industrial Average to plunge 1,000 points (9 percent) on May 6, 2010. More recently, some have accused algo-trading as responsible for a145-point market drop in response to a false tweet about a terrorist attack on the White House that was posted on a hacked Associated Press Twitter feed on April 23, 2013.

A May 1, 2013 *Wall Street Journal* exposé further charges that "High-speed traders are using a hidden facet of the Chicago Mercantile Exchange's computer system to trade on the direction of the futures market before other investors get the same information." According to the *Journal*, such trades are conducted by computers that have an advantage of just "one to 10 milliseconds" and allow the structure of orders "so that the confirmations tip which direction prices for crude oil, corn or other commodities are moving." The influence of HFT in commodities continues to grow. The article

[5] Link to the Senate PSI Wheat Report: http://bit.ly/WheatRpt (Accessed May 1, 2013)

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cites a Tabb Group estimate that HFT now comprises "about 61 percent of all futures market volume, up from 47 percent in 2008." Some market experts told the *Journal* that a failure to address this issue could result in market distortions, increased risks and the loss of liquidity.[6]

Thankfully, the CFTC has announced that it will investigate the role of High-Frequency trading in the commodity markets and evaluate the need for new regulations to protect market participants and preserve market integrity.[7] They are not alone. Lawmakers in Europe have become so concerned about this issue they have even proposed limiting or banning HFT in commodities markets altogether.[8] **We urge the committee to investigate the role of HFT and other potentially harmful or disruptive new trends in the commodity markets and determine whether or not additional CFTC authority is required to address these concerns.**

Penalties

Current law allows fines of up to $1 million per violation for manipulation or attempted manipulation and $140,000 for other violations of the CEA.[9] In practice, while the amount of these fines vary, they are often insignificant when compared to the overall profits of many market participants such as financial intuitions and may be doing little to deter violations of the law. In effect, for many large firms, these relatively miniscule fines just become part of the cost of doing business. Given this, **the committee should increase fines and penalties as appropriate in the CFTC Reauthorization Act in order to more effectively deter manipulation and other unlawful behavior.**

Additionally, the CFTC is restrained by the blanket five-year Statute of Limitations. This restricts the ability of Commissioners to prosecute violations of the CEA, including cases of fraud and manipulation. The existing five-year Statute of Limitations challenges the CFTC to prosecute cases despite a limited budget and personnel, the increasing complexity of the markets it regulates and the volume of data that must be collected and analyzed. **Therefore, the committee should extend the Statute of Limitations for the CFTC to a minimum of 10 years.**

Bankruptcy Protections

Following a series of brokerage-house bankruptcies in the late 1960s, Congress enacted the Securities Investor Protection Act (SIPA) of 1970 in order to extend FDIC-like protections to brokerage clients and to restore investor confidence.[10] The Act established the Securities Investor Protection Corporation (SIPC) to oversee the protection of customer funds and investments in the event of a broker-dealer failure and provide insurance coverage of up to $500,000 for the value of a customer's net equity, including up to $250,000 for cash accounts.

Unfortunately, Congress failed to extend SIPA protections to commodity brokerage clients, including commodity hedgers. It is likely that lawmakers simply did not foresee that commodity hedging would become as widespread as it is today. As a result, when the brokerage firm MF Global filed for bankruptcy 18 months ago, its clients lacked adequate federal protections for their funds, accounts and positions. They were thrown into the chaos and uncertainty of recovering their funds, a problem that could have been alleviated if SIPA-style protections existed for these customers.

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[6] "High-speed Traders Exploit Loophole," *The Wall Street Journal*, May 1, 2003. Link: http://on.wsj.com/15a3uVS (Accessed May 1, 2013)
[7] "Statement of Chairman Gary Gensler before the CFTC Technology Advisory Committee," April 30, 2013.
[8] "Europe to ban high-frequency trading in commodities," BullionStreet (blog), October 29, 2012. Link: http://bit.ly/15a3mG7 (Accessed May 1, 2013)
[9] 7 U.S.C. §13
[10] Pub.L.91-598

Therefore, we believe **the committee should enhance protections for commodity brokerage clients**, including:

- The prioritization of commodity brokerage clients' claims filed with bankruptcy Trustees;
- The creation of a new insurance fund for the protection of commodity brokerage clients that would provide similar protections as the SIPA-created securities investor insurance fund;
- The creation of a non-profit Commodity Futures Protection Corporation (CFPC) that will be separate from the Securities Investor Protection Corporation and oversee the remediation of customer funds in the event of a commodity broker-dealer failure and to manage the insurance fund associated with the new law; and
- A requirement, that in the event of a bankruptcy, the CFPC work with the CFTC, self-regulatory organizations and the courts in carrying out its mission, especially the restoration of client funds and the liquidation or transference of commodity positions.

When combined with enhanced customer protections currently being considered by the Commodity Futures Trading Commission, self-regulatory organizations, futures exchanges and brokerage firms, we believe that a futures insurance program will go a long way to restoring confidence in these markets. This is especially true for Main Street businesses, farmers and ranchers, and other industries that utilize futures, options and swaps to mitigate price risks and to help insulate their companies and their consumers from volatility and uncertainty.

Trade Options Exemption
The Dodd-Frank Act made it unlawful for anyone that is not an Eligible Contract Participant (ECP) to enter into an over-the-counter or off-exchange swap. In order to qualify as an ECP, an entity has to meet a $10 million net worth requirement, with a separate $1 million net worth requirement for *bona fide* hedgers. Although many small businesses, farmers and other end-users may qualify as an ECP, their net worth can often fluctuate, causing them to be unsure from time-to-time whether they satisfy the $1 million net worth requirement for hedgers. Moreover, an entity's net worth may have an inverse relationship with its liabilities; that is, as liabilities increase and the business finds itself with an urgent need to hedge, its net worth may decrease.

For businesses that do not qualify as ECPs and that hedge commodity prices through physically-settled bilateral options, the CFTC has proposed a "trade options exemption" in order to extend measured regulatory relief.[11] However, some CMOC members have recommended that the CFTC extend the trade options exemption to small hedgers that engage in "financially-settled," not just physically-settled, options.[12] Financially-settled options allow some third-party hedging firms serving small businesses to aggregate a collection of less-than-standard contract volumes into a single financially-settled option. The CFTC has not yet finalized the Trade Options rule. **We encourage the committee to consult with the CFTC on the status of the trade options exemption and, if necessary, take action to codify regulatory relief for small hedgers.**

Energy & Environmental Markets Advisory Committee
In response to unprecedented volatility in the energy markets and at the urging of members of this coalition, the CFTC established the Energy Markets Advisory Committee in June of 2008. The purpose of this advisory committee, according to then-Acting CFTC Chairman Walt Lukken, was to

[11] 17 CFR Parts 3, 32, and 33 Commodity Options; RIN 3038-AD62
[12] See NEFI and PMAA Joint Comments to the CFTC on the Trade Options Exemption, filed June 26, 2012.

assemble representatives from the energy industry, end-user groups and other market stakeholders to "ensur[e] that the Commission is fully informed of industry developments and innovations so that the Commission can rapidly respond to changing market conditions and ensure that these markets are not subject to foul play."[13] In 2009 the committee's charter was revised to include emerging environmental markets such as carbon trading markets and renamed the "Energy & Environmental Markets Advisory Committee" (EEMAC).

Congress clearly felt the EEMAC was important enough to make it permanent under Section 751 of the Dodd-Frank Act. Despite this, the advisory committee has only met three times since it was formed in 2008. Not a single meeting has been held since the EEMAC was made permanent in 2010.[14] Meanwhile, the CFTC's Agriculture Advisory Committee, Global Markets Advisory Committee and the Technology Advisory Committee have met over 20 times. **The committee should require the CFTC to establish a charter for the EEMAC by a date certain and require at least annual meetings to receive input from energy market stakeholders.**

Proposed House Legislation
On March 20, 2013, the House Committee on Agriculture approved legislation that would amend the CEA and Dodd-Frank Act reforms and, in some cases, intervene in on-going CFTC rulemakings. This legislation is now pending before the House Financial Services Committee. We understand that some members of Congress, financial institutions, trade associations and special interest groups are recommending this legislation be considered as part of CFTC reauthorization. Our coalition has been monitoring developments closely.

Below you will find our comments on this pending legislation:

H.R.634, the Business Risk Mitigation and Price Stabilization Act – H.R.634 would exempt from capital and margin requirements any swap in which one of the counterparties is (1) not a swaps dealer or major swaps participant, (2) a certain type of investment fund, (3) a mortgage lending institution, or (4) a commodity pool. Because it is in keeping with Congressional intent to provide relief from margin and capital requirements for legitimate commercial end-users, **our coalition supports this legislation** as long as exemptions from margin requirements remain narrow and do not include speculators, large financial institutions or other systemically significant market participants.

H.R.677, the Inter-affiliate Swap Clarification Act – H.R.677 would exempt inter-affiliate swaps (or, swaps between entities under common corporate ownership) from Dodd-Frank Act margin, clearing and reporting requirements. **Our coalition does not have a position on this legislation**. However, it is worth noting that the CFTC has already promulgated a generous exemption for inter-affiliate swaps and this legislation may be unnecessary.

H.R.742, the Swap Data Repository & Clearinghouse Indemnification Correction Act – H.R.742 would remove indemnification provisions included in Sections 728 and 763 of the Dodd-Frank Act to allow data sharing for swaps between U.S. and foreign regulators. CFTC Chairman Gary Gensler has acknowledged the need for a legislative fix to these indemnification provisions.[15] **Therefore, our coalition supports H.R.742 as a non-controversial technical correction.**

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[13] Opening Remarks of Committee Chairman Walter Lukken before the Energy Markets Advisory Committee," June 10, 2008.
[14] Meetings of the Energy & Environmental Markets Advisory Committee were held on June 10, 2008; May 13, 2009; and September 16, 2009.
[15] See Chairman Gensler's comments during the question and answer period of the "Hearing to Examine Legislative Improvements to Title VIII of the Dodd-Frank Act," House Agriculture Committee, March 14, 2013.

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H.R.992, the Swaps Regulatory Improvement Act – H.R.992 would repeal all of Section 716 of the Dodd-Frank Act (the so-called "Lincoln Amendment" or swaps "push-out" provision) except subsection (i), which prohibits the use of taxpayer funds to bail out swaps entities. This in effect would blur the line between depository banking and derivatives dealing (including in commodities) and extend to these risky investments the benefit of access to cheap money vis-à-vis the Federal Reserve discount window. Therefore, **our coalition opposes this legislation.**

H.R.1003 (no title) – H.R.1003 would repeal existing cost-benefit requirements under the CEA and require the CFTC to conduct more expansive and comprehensive analyses before approving regulations or orders. While an analysis of potential burdens on market participants should always be considered in the promulgation of any regulation, adequate cost-benefit requirements already exist in the CEA. We believe this legislation is politically-motivated with the intent of slowing down important new derivative market regulations. Therefore, **our coalition opposes this legislation.**

H.R.1038, the Public Power Risk Management Act – H.R.1038 allows public utilities to continue entering into energy swaps with government entities without being required to register with the CFTC as a swap dealer. Like H.R.634 above, this legislation is not inconsistent with Congressional intent to provide regulatory relief to *bona fide* hedgers that do not pose a systemic risk. Therefore, **our coalition supports this legislation** as long as exemptions are narrowly tailored.

H.R. 1256, the Swaps Jurisdiction Certainty Act – H.R.1256 would require the SEC and CFTC to jointly issue rules relating to swaps transactions between U.S. and non-U.S. persons. It would exempt from Dodd-Frank Act regulations a non-U.S. person found to be in compliance with the swaps regulations of any G20 member-nation; that is unless the SEC and CFTC jointly determine that the regulatory requirements are not "broadly equivalent" to U.S. swaps requirements. This legislation intervenes in ongoing negotiations between U.S. and foreign regulators regarding cross-border oversight of the derivatives markets. It could delay or undermine those efforts and even create a new "off-shore loophole" for systemically-significant entities or financial institutions seeking to evade U.S. regulations. Therefore, **our coalition opposes this legislation**.

Conclusion
Again, we appreciate the opportunity to provide input to the committee as it begins its work to draft legislation to reauthorize the CFTC. The CMOC and its member organizations stand ready to provide additional input to the committee as it continues its work.

Thank you in advance for your consideration.

Sincerely,

Airlines for America
American Bakers Association
American Feed Industry Association
American Trucking Associations
California Black Farmers & Agriculturalists Association
Colorado Petroleum Marketers Association
Connecticut Energy Marketers Association
Florida Petroleum Marketers Association
Fuel Merchants Association of New Jersey
Gasoline & Automotive Service Dealers of America
(Continued)

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Independent Connecticut Petroleum Association
Institute for Agriculture and Trade Policy
Louisiana Oil Marketers & Convenience Store Association
Maine Energy Marketers Association
Massachusetts Oilheat Council
Montana Petroleum Marketers & Convenience Store Association
National Association of Oil & Energy Service Professionals
National Association of Truckstop Operators
National Farmers Union
National Grange
National Latino Farmers & Ranchers Trade Association
New England Fuel Institute
New Mexico Petroleum Marketers Association
New York Oil Heating Association
North Dakota Petroleum Marketers Association
Ohio Petroleum Marketers & Convenience Store Association
Oil Heat Council of New Hampshire
Oil Heat Institute of Long Island
Oil Heat Institute of Rhode Island
Organization for Competitive Markets
Petroleum Marketers & Convenience Store Association Kansas
Petroleum Marketers & Convenience Stores of Iowa
Petroleum Marketers Association of America
Public Citizen
Ranchers-Cattlemen Action Legal Fund (R-CALF) USA
Utah Petroleum Marketers and Retailers Association
Vermont Fuel Dealers Association
West Virginia Oil Marketers and Grocers Association
Wyoming Petroleum Marketers Association

cc: The Honorable Frank Lucas, Chairman, House Committee on Agriculture
The Honorable Collin C. Peterson, Ranking Member, House Committee on Agriculture
The Honorable Gary Gensler, Chairman, Commodity Futures Trading Commission
The Honorable Jill E. Sommers, Commissioner, Commodity Futures Trading Commission
The Honorable Bart Chilton, Commissioner, Commodity Futures Trading Commission
The Honorable Scott D, O'Malia, Commodity Futures Trading Commission
The Honorable Mark P. Wetjen, Commodity Futures Trading Commission