May 2, 2013

The Honorable Debbie Stabenow
Chairman
Senate Agriculture Committee
U.S. Senate
328A Senate Office Building
Washington, DC 20510

The Honorable Thad Cochran
Ranking Member
Senate Agriculture Committee
U.S. Senate
328A Senate Office Building
Washington, DC 20510

Dear Chairwoman Stabenow and Ranking Member Cochran:

Better Markets[1] appreciates the invitation from the United States Senate Committee on Agriculture, Nutrition, and Forestry ("Committee") to comment on the upcoming Commodity Futures Trading Commission ("CFTC") and Commodity Exchange Act ("CEA") reauthorization process ("Reauthorization").

INTRODUCTION

The context of the present CFTC reauthorization is radically different from the last one in 2007. Since then, complex financial instruments have triggered and exacerbated the worst global financial crisis since the Great Crash of 1929 and the Great Depression of the 1930s. This has dramatically impacted the American taxpayer and economy. Indeed, our analysis shows that the financial collapse and the economic crisis it caused, which continues to this day, will cost the United States more than $12.8 trillion, ultimately affecting every person, family, and community in the United States.

The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") tasked the CFTC with regulating many of the complex instruments that played a central role in the crisis. As a consequence, the future stability of the financial system and economy depend to a great extent on the CFTC performing its regulatory role adequately. The CFTC reauthorization process must therefore ensure that the CFTC is adequately equipped in both authority and funding so that it may fulfill its legal duties and protect the American people, the financial system, and the entire economy from another devastating financial crisis.

The Dodd-Frank Act itself is an important and historic piece of legislation that should not be weakened. The suggestions below are intended to supplement the existing statutory framework in order to make it more effective as it pertains to the CEA.

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

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SUMMARY OF COMMENTS

- Review of Dodd-Frank Act Implementation Activities

  The CFTC has taken a leading role in implementing financial reform. It has outperformed the other agencies and now needs support as it attempts to finalize and enforce the new regulatory regime for derivatives.

- The CFTC Cannot Carry Out Its New Regulatory Responsibilities Without Sufficient Funding

  The lack of funding at the CFTC threatens to undermine Title VII of the Dodd-Frank Act. The Committee should examine ways in which it can ensure proper resources are available to the agency, including a possible deficit neutral self-funding model.

- The CFTC's Effectiveness Can Be Greatly Increased by Extending its Data-Gathering Authority

  The Dodd-Frank Act opened up vast new areas of data to the CFTC. However, there are important areas that remain in the dark. Specifically, Commodity Index Funds, Physical Commodity Holdings by Financial Institutions, and High Frequency Trading are three areas in which the CFTC's data collection authorities should be strengthened.

- Four Further Critical Issues to Consider:
  - *CFTC Penalty Authority*
  - *Absolute Limits on Financial Speculation in Commodities*
  - *Bona Fide Hedging*
  - *Updating the SRO Model*

DISCUSSION

Review of Dodd-Frank Act Implementation and Other CFTC Activities

The CFTC is the primary derivatives regulator in the U.S. and is in charge of ensuring the transparency, stability, fairness, and integrity of most of the $647 trillion dark derivatives market. It was in this shadowy market that the last financial crisis was invisibly incubated, with poorly collateralized, opaque derivatives exposures acting as a conveyor belt to transmit the crisis throughout the U.S. and global financial system. That financial collapse was the worst since the Great Crash of 1929 and has caused the worst economy since the Great Depression. The costs of that have been crippling, as an economic, fiscal, and human matter. That is what gave rise to the financial reform law in general and derivatives reforms in particular.

The passage of the Dodd-Frank Act, with its numerous comprehensive financial reforms, left the CFTC with the enormously important task of bringing the opaque derivatives markets under its oversight. The Commission has been diligently and expeditiously working towards finalizing the congressionally mandated rulemaking process to bring those reforms to life. As of April 30, 2013, the Commission has proposed 67 rules and finalized 46 of them.[2] Chairman Gary Gensler recently stated that the Commission has met more than 2,000 times with members of the public and has held 23 public roundtables.[3] Moreover, the Commission has received and reviewed more than 39,000 comment letters on matters related to reform.

The CFTC has successfully implemented large portions of derivatives reform, setting the foundation for the new derivatives marketplace mandated by the Dodd-Frank Act. Rules have been finalized that create a mandate for certain swaps to be traded on Swap Execution Facilities ("SEFs") and cleared through Derivatives Clearing Organizations ("DCOs"), with the data from these transactions being reported to Swap Data Repositories ("SDRs"). The largest participants in these markets must register as Swap Dealers ("SDs") or Major Swap Participants ("MSPs"), who are subject to additional oversight, including external and internal business conduct standards, capital and risk management requirements, and reporting obligations.

These rules are not perfect. For instance, the rules defining MSPs are so lax they fail to capture a single entity within their definition, and the external business conduct standards for SDs and MSPs are regrettably weak. Nevertheless, the CFTC is to be commended for taking a leading role in pushing forward the congressionally-mandated reform agenda. A number of other agencies tasked with implementing Dodd-Frank are significantly behind the timeline required by the act. However, the CFTC is far ahead of the other agencies despite facing significant obstacles, including limited personnel and funding.

In addition to undertaking its specific Dodd-Frank Act rulemakings, the CFTC has also led the charge in the historic actions regarding benchmark rates, including the London Interbank Offered Rate ("LIBOR"). Today, LIBOR is the reference rate for 70 percent of the U.S. futures market, most of the swaps market and nearly half of U.S. adjustable rate mortgages.[4] The Commission has successfully brought three cases against Barclays, UBS, and RBS for manipulative conduct with respect to LIBOR and other benchmark interest rate submissions.[5] These cases resulted in $2.5 billion in

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2 *See* http://www.cftc.gov/LawRegulation/DoddFrankAct/Dodd-FrankProposedRules/index.htm.

3 Testimony of Chairman Gary Gensler, Commodity Futures Trading Commission before the U.S. Senate Permanent Subcommittee on Investigations (July 21, 2008), *available at* www.hsgac.senate.gov/download/**stmt-gensler-cftcjuly-21-09-psi-wheat-hrg**.

4 Remarks of Chairman Gary Gensler on Libor before the Global Financial Markets Association's Future of Global Benchmarks Conference (February 28, 2013), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-133.

5 Remarks of Chairman Gary Gensler at London City Week on Benchmark Interest Rates (April 22, 2013), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-140.

fines.[6] More recently, it was reported that the CFTC has launched an investigation into possible manipulation in the ISDAfix benchmark interest rate swaps market.[7]

These actions are critical because fair and transparent markets must be free from fraud, manipulation, and criminality. Moreover, they are the foundation for a stable derivatives marketplace. The CFTC commitment to enforcing the law in the derivatives markets is an important example that should be followed by other regulators.

Although they have commendably done a great deal, the CFTC's hard work is not over. Much remains to be done. Worse, without the right leadership and proper funding, much of what the CFTC has accomplished can be undone. The enemies of financial reform, those seeking to protect profits, business lines, and bonuses above all else, thrive on dark, unregulated markets that can be manipulated, as well as unenforced laws or weak penalties. They have laid siege to the CFTC, burying it in mountains of paperwork, meeting requests, repeated threats of lawsuits, and, ultimately, lawsuits. In spite of all this, the CFTC has remarkably accomplished much, but it now needs more authority and funding to finish the job Congress assigned it and to put in place the protections the American people have been awaiting for almost five long years now.

CFTC Cannot Carry Out Its New Regulatory Responsibilities Without Sufficient Funding

While the Committee does not have jurisdiction over CFTC appropriations, it is nevertheless a key venue to discuss the agency's funding needs. At the present moment, with the economy still struggling to recover from a cataclysmic financial crisis, a repeat of which could well occur if not for the CFTC's new legal duties and responsibilities, this issue is more urgent than ever.

On September 15, 2012, Better Markets issued a report on the the costs of the financial collapse and ongoing economic crisis. That report conservatively estimates that the sum of actual GDP loss and GDP loss avoided will total more than $12.8 trillion for the period 2008-2018.[8] This figure is consistent with the recent GAO report, "Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act," which states that those losses could exceed $13 trillion.[9]

In the context of a $12.8 trillion cost to just the United States alone, replenishing the starved CFTC budget to the approximately $300 million level required for it to do its job

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6 *Id.*

7 Leising, M., ISDAfix Probe Unveils Benchmark Affecting Bonds to Annuities, Bloomberg (April 15, 2013), *available at* http://www.bloomberg.com/news/2013-04-14/isdafix-probe-unveils-obscure-rate-affecting-bonds-to-annuities.html.

8 *See* Better Markets, "The Cost Of The Wall Street-Caused Financial Collapse and Ongoing Economic Crisis is More Than $12.8 Trillion," *available at* www.bettermarkets.com/cost-crisis.

9 *See* U.S. GOVERNMENT ACCOUNTABILITY OFFICE, FINANCIAL REGULATORY REFORM: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT, GAO-13-180, at 17 (Jan. 2013), *available at* http://gao.gov/assets/660/651322.pdf.

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must clearly be a priority.[10] This funding will enable the CFTC to progress in terms of manpower and technology, and to the extent the Committee can play a role in moving this forward, it will be a worthwhile and necessary first step. Taking a long-term view, the Committee should also consider whether self-funding through transaction, trade, quote or related charges, or – at a minimum – a deficit neutral funding model along the lines of that employed by the SEC might be a viable alternative.

Derivatives are no doubt here to stay, and they have become deeply entangled in our nation's financial system. For the primary regulator of these huge and important markets to live the equivalent of paycheck-to-paycheck is clearly unacceptable and a gross disservice to the American people, who have already suffered so much.

There is simply no denying that the next crisis will not be prevented unless the regulators have the resources to do their job.

Staffing and Technology: Two Necessary Areas of Improvement

To ensure that the CFTC can promptly finalize all pending rules under the Dodd-Frank Act and, equally important, enforce them effectively, it is absolutely critical that the Commission is properly staffed and has the sufficient level of funding to improve its long overdue technology. As Commissioner Scott O'Malia has pointed out, the current technological limitations at the agency mean even an event as significant as JP Morgan Chase's so-called "London Whale" fiasco[11] would currently go undetected, since "none of our computer programs load [Swap Data Repository] data without crashing."[12]

This technological mismatch is directly caused by the rising tendency of exchanges to sell or allow lucrative privileged data feeds to powerful market participants, encouraging a proliferation of algorithmic trading and High Frequency Trading ("HFT") in derivatives markets.[13] The Committee might consider whether a portion of such revenues should be required by law to support the agency responsible for regulating and monitoring this high tech minefield. This would enable the CFTC to keep pace with the changing technology of the marketplace.

But technology is useless without the right staff to utilize it, and staffing is an urgent issue at the CFTC. From 1999 to 2007, the agency shrunk from 567 full-time

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10 Hamilton, J., Gensler Wants 50 Percent More CFTC Money for Dodd-Frank Work (March 21, 2012), *available at* http://www.bloomberg.com/news/2012-03-21/gensler-wants-50-percent-more-cftc-money-for-dodd-frank-work.html.

11 U.S. Senate Permanent Subcommittee on Investigations, "JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses" ("PSI Report")(March 15, 2013), *available at* http://www.hsgac.senate.gov/download/report-jpmorgan-chase-whale-trades-a-case-history-of-derivatives-risks-and-abuses-march-15-2013.

12 Brush, S., Dodd-Frank Swap Data Fails to Catch JPMorgan Whale, O'Malia Says (March 19, 2013), *available at* http://www.bloomberg.com/news/2013-03-19/dodd-frank-swap-data-fails-to-catch-jpmorgan-whale-o-malia-says.html.

13 *See* High Speed Traders Exploit Loopholes, Patterson, J., et. al, (May 1, 2013), Wall Street Journal, available at http://online.wsj.com/article/SB10001424127887323798104578455032466082920.html?mod=WSJ_hps_LEFTTopStories .

equivalents ("FTEs") to 437. Currently, the CFTC has 690 FTEs which is less than 10 percent more than at the peak in the 1990s.[14] Comparably, the volume of futures trading in the United States from 2000 to 2013 has exploded from 491 million contracts per year to over 9 billion contracts per year.[15] Also, the Dodd-Frank Act, for the first time, mandates the Commission to regulate the United States swaps markets, which is estimated to be approximately $340 trillion in notional value.[16] Under the Dodd-Frank Act, there will also be hundreds of new registrants such as SEFs, DCOs, and SDRs. These entities must be periodically inspected and examined to ensure that they have adequate compliance systems and procedures, and are actually using those systems to comply with the law. All this requires talented, experienced, and trained personnel, and that does not even address the CFTC's many other duties such as enforcement.

At the current staff level, the Commission would be critically understaffed even if it was only obligated to carry out its pre-Dodd-Frank responsibilities. The essential new responsibilities and authorities assigned to the CFTC under the Dodd-Frank Act only make that understaffing more severe and unacceptable. It is now known that the Commission has been unable to conduct annual examinations on major entities in 2012 due to limited resources and additional responsibilities.[17] This is simply not tolerable. Without properly designed examination programs and well-trained staff to carry out such examinations, the next LIBOR-style rate manipulation, the next MF Global-style fraud, and the next financial crisis currently being incubated unseen simply will not be identified and stopped.

To address the agency's grossly underfunded budget, the President requested $308 million and 1,015 FTEs for the fiscal year 2013.[18] If Congress does not provide sufficient funding to the CFTC and allow the Commission to properly monitor the markets and enforce its rules in the near future, it is not unreasonable to see another financial crisis looming just around the corner. Needless to say, some on Wall Street would welcome this news because underfunding the CFT is just like taking the police off the streets in a high-crime area. Risky trading in dark markets is highly profitable to many on Wall Street and very expensive for every other person in America. Wall Street received billions in bonuses while the U.S. taxpayers got the bill for trillions of dollars to clean up their mess. The only way to prevent them from doing that again is to make sure that the CFTC has the funds to do its job.

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[14] Testimony of Gary Gensler, Chairman, Commodity Futures Trading Commission before the U.S. Senate Banking, Housing and Urban Affairs Committee, Washington, DC (February 14, 2013), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-131.

[15] Acworth, W., Volume Climbs 11.4% to 25 Billion Contracts Worldwide, http://www.futuresindustry.org/files/css/magazineArticles/article-1383.pdf

[16] Gensler, G., Remarks on Dodd-Frank Financial Reform at George Washington University Law School (March 2, 2012), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-106.

[17] Commodity Futures Trading Commission Annual Performance Report, Fiscal Year 2012, *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/2012apr.pdf.

[18] Commodity Futures Trading Commission President's Budget and Performance Plan, Fiscal Year 2014, *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2014.pdf.

The CFTC's Effectiveness Can Be Greatly Increased by Extending its Data-Gathering Authority

One of the main goals of the Dodd-Frank Act is transparency. To achieve this, the Commission has promulgated and finalized several rules to improve reporting obligations.[19] The Commission will be receiving voluminous new market data which must be organized, processed, and analyzed.

Nevertheless, several key areas of the markets remain dark, and the CFTC Reauthorization process represents an opportunity to address that. In particular, CFTC registration requirements should be expanded to cover:

- **all** funds providing returns benchmarked to the prices of physical commodities or their derivatives;
- **all** financial firms with physical commodity holdings; and
- **all** algorithmic traders and HFTs.

This would significantly boost the quality of the data available for policy-informed research, market surveillance and oversight, as well as enforcement within the CFTC.

Commodity Index Funds

Since 2008, a debate has raged over the impact of commodity index funds on food and energy prices. Today, the real debate is no longer whether or not these funds distort market prices, but rather how large their impact is.[20] Congressionally-mandated collection of data on the activities of index funds would shed new light on this discussion, and would enable a truly informed and scientific analysis which would be to the benefit of all market participants, including in particular *bona fide* market participants.[21]

Mandatory registration of these firms with the CFTC would enhance the CFTC's ability to collect data and otherwise regulate these traders' participation in commodity markets to a level where their impact on the markets could be understood and measured. In addition, where appropriate, the negative impact of such trading could be significantly reduced based on this market data. Importantly, firms engaged in this massive commodity index trading are sophisticated operations which already have the systems in place that produce this data on a routine basis. Providing such data to the

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[19] Commodity Futures Trading Commission, Data Recordkeeping & Reporting Requirements, *available at* http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_17_Recordkeeping/index.htm.

[20] For a list of over 100 studies and articles finding that commodity index fund trading distorts commodity prices, see http://www2.weed-online.org/uploads/evidence_on_impact_of_commodity_speculation.pdf.

[21] Such data would also enhance the ability of the CFTC to cap the participation of commodity index traders to a target level. In Better Markets' comment letter to the CFTC's January 2011 position limits proposal (dated March 28, 2011), Better Markets suggested capping commodity index trader participation to 10 percent of open interest.

CFTC would, therefore, not be burdensome or costly, but would provide an immeasurable benefit to regulators, the markets, and the public.

"Commodity index trader" should be defined to include any account, fund, commodity pool, or other investment vehicle that provides returns to investors benchmarked to one or more physical commodities or their derivatives.[22] Furthermore, so that the existing authority is even more clear, the CFTC's authority to restrict such trading or to attach conditions to such trading (including public disclosure obligations of the type required under securities laws for publicly-traded commodity index funds[23]), should specify that this group of traders – or any sub-group thereof – qualifies as a "group or class of traders" under the CEA for position limits purposes.

To the extent that commodity index traders' activities in commodity markets are appropriately regulated, *bona fide* market participants and the American consumer will benefit. Further, if the money in excess of appropriate, historically consistent amounts of commodity investment were invested elsewhere, the public would also benefit. [24] Congress should provide the CFTC with additional direction and discretion to deal with commodity index traders in a manner consistent with the public interest.

Physical Commodity Holdings of Financial Firms

It is now widely known that banks have taken ownership of significant amounts of physical commodities and storage facilities.[25] The reported levels of ownership – with a single bank in some cases owning 25 percent of deliverable supply – are a clear threat

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22 This definition should include electronically-traded funds (ETFs) backed by physical commodity assets. This definition should also include objective criteria for determining whether an investment vehicle is a "commodity index trader." Such objective criteria may include (1) that the vehicle is net long (or short) in all commodities in which they hold a position greater than 90% of the time and (2) that 90% or more of the replacement value of the fund is allocated to the vehicle's long (or short) exposures. An objective definition of this sort should be sufficiently flexible to cover funds that are restructured in order to avoid classification as a commodity index trader.

23 Such disclosure obligations would enhance the ability of investors to evaluate these investments. *See e.g.,* ETFs Imperil Investors as Contango, Pre-Roll Conspire, Bloomberg BusinessWeek, *available at* http://www.bloomberg.com/news/2010-07-22/etfs-imperil-commodity-investors-when-contango-conspires-with-pre-rolling.html. These disclosure obligations would also enable the market to distinguish between informed non-index-related trading and trading initiated by commodity index investors and therefore mitigate the harmful impact of the latter.

24 Some of this money would likely find itself in commodity-linked equities that would, in turn, result in greater investments in commodity production and processing, thereby reducing pressures on physical commodity prices. Other money re-allocated from commodity index investment would find itself in actively-managed commodity funds that would provide genuine liquidity to bona fide hedgers, in contrast to commodity index funds which absorb liquidity.

25 Sheppard, D., Leff, J., and Mason, J., Insight: Wall Street, Fed face off over physical commodities, Reuters (March 2, 2012), *available at* http://www.reuters.com/article/2012/03/02/us-fed-banks-commodities-idUSTRE8211CC20120302.

to the orderly functioning of commodities markets.[26] Yet the precise levels of these holdings remain unknown.

The Reauthorization process represents an opportunity to close this material gap in reporting requirements, which were never previously necessary due to the fact that never before have banks owned physical commodities, and never in such large, market-moving quantities. Indeed, it was illegal for them to do so until the recent weakening of restrictions by the bank regulators.[27] This dramatic change requires data gathering, review, and, where appropriate, regulation.

High Frequency Trading

HFT[28] is another new threat to the marketplace that could not have been foreseen by previous drafters of the CEA.[29] Indeed, we view it as one of the most important issues facing the U.S. markets today, especially as the the new emerging derivatives markets infrastructure is being put in place as required by the Dodd-Frank Act.

Better Markets addressed this issue in testimony before this Committee on July 17, 2012, when Chairman Stabenow asked, "We're focused on important reforms in Dodd-Frank, but from your perspective, what else should we be paying attention to as we look to protect the economy and strengthen these markets?" Mr. Kelleher testified as follows:

> "... The second issue that really needs to be focused on that hasn't gotten much attention that we've tried to raise in 5 or so comment letters to CFTC is high-frequency trading, which is currently -- the predatory conduct associated with that in our equity markets is causing the confidence in those markets to drop to one of the lowest ebbs ever. And that -- that type of trading and predatory conduct is going to move into the new market infrastructure that's created in the commodity markets.
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> And you all are going to be here, mark my words, in future years, trying to figure out how to deal with those computer predators, in

26 Desai, P., Baldwin, C., Thomas, S., and Burton, M., Goldman's new money machine: warehouses, Reuters (July 29, 2011), *available at* http://www.reuters.com/article/2011/07/29/us-lme-warehousing-idUSTRE76R3YZ20110729.

27 Chanjaroen, C., Morgan Stanley Will Seek Further Fed Exemption in Commodities, Bloomberg (September 24, 2008), *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=arV.SiJ8Bm8M.

28 While "HFT" is the commonly used term for high-speed computer activity in the markets today (and for that reason we use it in this letter), it is misleading to say the least. It would be much more accurate to call such high speed computer activity "high frequency quoting" because according to some reports as much as 99% of all computer generated quotes **do not** result in market trades. As we have detailed elsewhere, much of what is referred to as "HFT" appears to be for manipulative, if not fraudulent, purposes. *See* http://www.citizen.org/documents/hauptman-testimony-on-computerized-trading.pdf.

29 Patterson, S., Strasburg, J., and Pleven, L. High-Speed Traders Exploit Loophole, Wall Street Journal (May 1, 2013), *available at* http://online.wsj.com/article/SB10001424127887323798104578455032466082920.html.

> the same way, in the past, we tried to deal with the Peregrines and the people predators of the past, the computer predators of the future are not getting the attention. And now's the perfect time to start thinking about that. As you put this market infrastructure in place, you have the opportunity to address that on the front end, instead of having to address it after the fact, when you've got victims across the land."[30]

New data collection authorities specific to HFT are critical and would at the very least allow the CFTC to begin to take a systematic look at the behaviors and impact of high-speed computer trading generally (inclusive of HFT, but not limited to it, however defined). This would also help the CFTC enforce anti-disruptive trading practices and other anti-manipulation rules, which many market participants believe are being openly flouted by what is referred to as HFT.[31] As with commodity index funds, mandatory registration of all commodity HFTs with the CFTC is an essential first step.

The Committee may also wish to consider developing a definition of HFT for CEA purposes. The CFTC's Technology Advisory Committee has so far failed to come up with an appropriate definition of HFT due to an over-reliance on special interest groups from the financial industry. In addition, the Committee ought to clarify that HFTs , as well as any sub-groups thereof, constitute a "group or class of trader" for purposes of applying position limits.

Three Further Critical Issues to Consider

Beyond the above suggestions, there are four further key areas into which the Committee should look when considering updates to the CEA during the CFTC Reauthorization process.

CFTC Penalty Authority

At present, the CFTC's maximum penalty authority is tied to the gains accruing to the rule breaker. This is appropriate for manipulation and other activities that bring profit. However, a failure of compliance, a loss-making transgression, or a failed manipulation attempt may only allow maximum penalties that are paltry in comparison to the gravity of the offence. If penalties are not commensurate to the severity of the offenses, the incentives to comply with regulations are eroded, and the entire regulatory infrastructure and financial system itself is undermined. The Committee should therefore consider setting monetary penalties for individuals and entities at much higher than current levels to ensure that those penalties serve the critically important purposes of punishment and deterrence.

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30 Senate Committee on Agriculture Hearing "Dodd-Frank Wall Street Reform and Consumer Protection Act: 2 Years Later (July 17, 2012), *available at* http://www.ag.senate.gov/hearings/-dodd-frank-wall-street-reform-and-consumer-protection-act-2-years-later-.

31 Institutional investors air HFT concerns, Financial Times (September 12, 2011), *available at* http://www.ft.com/intl/cms/s/0/d05f1e1e-dd0b-11e0-b4f2-00144feabdc0.html#axzz2S4D4xFCz.

At a minimum, the Committee should raise the maximum penalty for **all** violations of the CEA to the greater of three times the illicit gains or $1 million for individuals and $10 million for entities. This is an important fix, as it would enable the CFTC to impose more appropriate penalties not just for manipulation but for other violations of the CEA.[32] Currently, the maximum penalty for violations that do not constitute manipulation are considerably lower than for those that do.[33] However, this is an artifact of an outdated framework that was developed before the era in which CEA-covered financial instruments can now cause the entire financial system to collapse. In this new environment, the CFTC needs adequate authority to appropriately penalize violations that may be hugely significant in their possible consequences despite not constituting manipulation.

Absolute Limits on Financial Speculation in Commodities

The CFTC has interpreted the position limits requirement of the Dodd-Frank Act to entail limiting the contracts held by any non-commercial market participant. However, it has not tied this to the aggregate level of speculation in the market as a whole. There is academic evidence suggesting that the aggregate level of speculation in the market influences the behavior of prices, and that more speculation does not always mean more efficient prices. The Committee should consider that stipulating a maximum overall level of speculation in the market may help to generate an orderly market, in which prices are more indicative of supply and demand. This would, of course, translate into individual limits, which would then be set at a level to, in the aggregate, keep speculation within the overall limit.

A corollary of this is that the Committee should consider further defining the concept of excessive speculation. Common sense would dictate that if the speculators in a market outnumber the *bona fide* hedgers then prices are by definition determined more by speculators than by hedgers. Therefore, a presumption that a market is excessively speculative when speculators outnumber commercial participants would seem warranted. In the past, this was not necessary, as it is only recently that speculators have come to dominate various commodity markets. Certain markets might be exempted by the CFTC (like electricity or natural gas), depending on specific considerations pertaining to those markets.

Bona Fide Hedging

The concept of *bona fide* hedging is central to Title VII of the Dodd-Frank Act. Various key rules ranging from Swap Dealer registration to position limits to the clearing mandate hinge upon the definition of *bona fide* hedging. And yet, this definition – upon which so much hinges – is left open to the CFTC's discretion. As a consequence of this, different definitions have been applied in different contexts, and some definitions adopted by the CFTC have been wholly inappropriate for their intended use. Enacting a congressionally determined definition of *bona fide* hedging into the CEA would remove

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[32] 17 CFR 143.8.

[33] *Id.*

this ambiguity and inconsistency, and ensure that the definition used by the CFTC is suitable.

While the exact definition would require deliberation and perhaps hearings, in broad outline it is clear that it should include certain elements. First, *bona fide* hedging should be tied to specific lines of business and specific contracts. It is conceivable (and indeed likely) that part of an entity's book constitute *bona fide* hedging and another part not. Second, a *bona fide* hedge must be commensurate to the risk it is designated to hedge. In other words, an entity ought to be able to point to the business line it is hedging and demonstrate that the size of its derivatives positions that it claims as a hedge are appropriate for the commercial activities of that business line. Third, *a bona fide* hedge should not create complex new risks such as convexity.

These principles were clearly violated in the supposed "hedge" positions that caused the London Whale fiasco.[34] No doubt countless other positions within financial institutions and commercial firms deserve further scrutiny as to their suitability as a "hedge." It is simply not right that risky derivatives trades with no direct economic purpose be allowed to take place outside of the regulated system, with exemptions from position limits and clearing requirements. Not only does this build systemic risk, it also diverts capital away from productive uses at a time when the United States economy can ill afford to be under-supplied with capital simply to fuel the gambling habits and bonus addiction of a few to the detriment of the many.

Updating the SRO Model

The catastrophic failure of CME to monitor or oversee MF Global makes it clear that the era of self-regulating futures exchanges has run its course.[35] The conflicts of interest inherent in allowing an organization that depends on trade volume for revenues to police the members that provide that volume are simply too powerful to ignore. The expansion of the futures markets over recent years, as well as the recent "futurization" wave that is bringing swaps onto DCMs like CME by replacing them with economically equivalent futures contracts means the stakes are higher than ever.

The over-broad discretion granted to the exchanges has also been abused, as recently demonstrated by the decision of the Intercontinental Exchange ("ICE") to set block trade thresholds so low for their newly "futurized" energy contracts that the **majority** of the market now trades as blocks – a designation that is meant to exempt only a small portion of extremely large trades from transparency requirements due to their potential to move markets. This undercuts one of the primary rationales for exchange trading: transparency, which leads to a fair market with useful price discovery for all participants, not a select few who may take advantage of the many. Put another way, the opaque, unregulated OTC market is being revived under the guise of setting a block trade threshold.

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34 PSI Report, at 103.

35 Protess, B., and Ahmed, A., MF Global Inquiry Turns to Its Primary Regulator (January 5, 2012), *available at* http://dealbook.nytimes.com/2012/01/05/mf-global-inquiry-turns-to-its-primary-regulator/.

This action and others, like the "futurization" of opaque OTC swaps, not only imports the shadowy OTC model onto the futures exchanges, but is a clear violation of the intent of the Dodd-Frank Act. This outdated SRO model is no longer suitable in a day and age where so much profit is at stake due to the newly opened up swaps markets. This is especially true since that profit is closely tied to instruments that were heavily implicated in the last financial crisis and could easily trigger the next one if they are not comprehensively and effectively regulated.

Too often, the SROs have proven that they are unwilling or unable to self-regulate to the requisite standards. This was clearly illustrated by the failure of the National Futures Association to adequately monitor Peregrine Financial, despite numerous audit irregularities and tip-offs that serious wrongdoing was occurring.

The fact is that allowing an industry to police its own members necessarily results in colossal conflict of interests. Therefore, the Committee should consider replacing the SRO model entirely with an oversight system where the markets are properly policed by an adequately funded CFTC.

Short of this approach, and at a minimum, the Committee should consider steps aimed at restructuring the current SRO framework. In the securities arena, FINRA was created from the consolidation of the NASD and NYSE Regulation in 2007, reflecting in part a recognition that greater uniformity in regulation between competing SROs would help avoid a regulatory race to the bottom. The Committee should analyze whether or not the consolidation has in fact avoided a regulatory race to the bottom and what other or different steps may be necessary. Furthermore, the excessive power that the SROs enjoy today should be taken out of the exchanges themselves and replaced by an external entity with more modest authority, limited to licensing and data collection, with rule-making and enforcement left exclusively in the hands of the un-conflicted regulator.

The importance of reforming the SRO model in the derivatives space cannot be overstated. With the former OTC markets coming onto exchange-like venues, including the largest, systemically important SROs, incentives are changing at a pace that the outdated self-regulatory structure cannot keep up with. Whether the Committee ultimately decides that the self-regulatory arms of the large exchanges should be consolidated like FINRA, and whether their authority needs to be scaled back, is something that will depend on hearings and deliberations. But these and other options – including abolishing the SRO structure within the commodities space entirely – should be an important part of the Reauthorization review process.

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CONCLUSION

We hope you find these comments useful.

Sincerely,

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