S. Hrg. 113–248

REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

JULY 17, 2014

Printed for the use of the
Committee on Agriculture, Nutrition and Forestry

REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

S. HRG. 113–248

REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

JULY 17, 2013

Printed for the use of the
Committee on Agriculture, Nutrition and Forestry

Available via the World Wide Web: http://www.fdsys.gov/

U.S. GOVERNMENT PRINTING OFFICE

87–566 PDF WASHINGTON : 2014

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

DEBBIE STABENOW, Michigan, *Chairwoman*

PATRICK J. LEAHY, Vermont	THAD COCHRAN, Mississippi
TOM HARKIN, Iowa	MITCH McCONNELL, Kentucky
MAX BAUCUS, Montana	PAT ROBERTS, Kansas
SHERROD BROWN, Ohio	SAXBY CHAMBLISS, Georgia
AMY KLOBUCHAR, Minnesota	JOHN BOOZMAN, Arkansas
MICHAEL BENNET, Colorado	JOHN HOEVEN, North Dakota
KIRSTEN GILLIBRAND, New York	MIKE JOHANNS, Nebraska
JOE DONNELLY, Indiana	CHARLES E. GRASSLEY, Iowa
HEIDI HEITKAMP, North Dakota	JOHN THUNE, South Dakota
ROBERT P. CASEY, Jr., Pennsylvania	

CHRISTOPHER J. ADAMO, *Majority Staff Director*
JONATHAN W. COPPESS, *Majority Chief Counsel*
JESSICA L. WILLIAMS, *Chief Clerk*
THOMAS ALLEN HAWKS, *Minority Staff Director*
ANNE C. HAZLETT, *Minority Chief Counsel and Senior Advisor*

CONTENTS

REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

Wednesday, July 17, 2013

UNITED STATES SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY,
Washington, DC

The Committee met, pursuant to notice, at 2:37 p.m., in room 216, Hart Senate Office Building, Hon. Debbie Stabenow, Chairwoman of the Committee, presiding.

Present: Senators Stabenow, Brown, Klobuchar, Gillibrand, Heitkamp, Donnelly, Cochran, Roberts, Chambliss, Boozman, Johanns, Grassley, and Thune.

STATEMENT OF HON. DEBBIE STABENOW, U.S. SENATOR FROM THE STATE OF MICHIGAN, CHAIRWOMAN, COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

Chairwoman STABENOW. Well, good afternoon. The Committee on Agriculture, Nutrition, and Forestry will come to order. We appreciate all of our witnesses today. We do have two very important panels with a lot of witnesses to hear from, and we are looking forward to doing that today in a timely manner as well as follow-up discussions.

I should also note for members that we may very well be interrupted on votes. We are hoping that they will hold off on that, but we may be. If we are, we will apologize in advance, but I know that most of you know how this works in terms of going down to the votes. And so we will manage it if it comes.

We do have some business, a housekeeping matter that we need to attend to as we begin our hearing, and that is, Senator Casey is coming—I see that he is not here at the moment, but he is now coming back to our Committee. Senator Cowan was on the Committee during his time in the Senate. Senator Casey was gracious enough to step aside to other committees so that Senator Cowan could serve on the Agriculture Committee. He will now be assuming Senator Cowan's Subcommittee assignments, and we have the good fortune of having them be identical to the assignments that Senator Casey had when he left us. So we know that he will come back as Chairman of the Subcommittee on Nutrition, Specialty Crops, Food, and Agricultural Research. So we have no official items at this point other than to welcome him back to the Committee, and we will do that when he arrives.

In the more than 150 years that we have had futures markets in this country, there have been cases that test the stability of the system. In the 1950s, a pair of traders in Chicago were able to corner the market on onions. They bought shorts on onions and flooded the market, driving the price down to pennies. Farmers in the Midwest were devastated and many had to file bankruptcy.

As devastating as the onion scandal was to those farmers in Michigan and Indiana, and Illinois, it was nothing compared to the near collapse of the global financial markets in 2008. We cannot forget that 8 million hardworking men and women lost their jobs. Pensions and retirement savings went up in smoke. A record wave of home foreclosures swept across the countries, leaving devastated communities in the wake. There was no question that we needed serious market reform.

As this Committee begins the process of reauthorizing the Commodity Futures Trading Commission, we need to examine the lessons from the past and consider ongoing challenges in the system. We want to make sure the agencies responsible for protecting these markets have the authority, the staff, and modern technology that they need to do the job.

This Committee has been closely monitoring the MF Global case where customers' funds, money that rightly belonged for farmers and businesses and individuals all across the country, went missing. We continue to focus on three goals: getting customers their money back—and certainly there has been terrific progress there; holding anyone engaged in wrongdoing accountable; and ensuring that proper customer protections are in place so that something like this does not happen again.

I appreciate the important steps the Trustees, market participants, and the Commission have already taken toward that objective, but we all know there is more work to do.

As several witnesses will testify today, there are lessons to be learned not just from MF Global's failure but also that of Peregrine Financial Group. The cause of their failures may be different, but the resulting effect on customer confidence is the same.

These markets have also been tested by the LIBOR scandal, data security breaches, occasionally unexplained price volatilities, and technology challenges that raise serious concerns about the ability of our markets to protect consumers.

I am eager to hear from market participants testifying today about their suggestions and concerns for improving the CFTC and how these markets are supervised and protected.

As we begin the reauthorization process, let me say again, as we all know in our Committee, that we will work together like we did on the farm bill. It will be collaborative, it will be bipartisan, it will be consensus driven, and it will lead to success because we work together. We intend to use that model as we look at reauthorizing the CFTC.

In the coming weeks, we will announce additional hearings as well as staff briefings that more closely examine the issues presented to us today, and I look forward to working with my distinguished Ranking Member, Senator Cochran, and all of the very experienced and distinguished members of the Committee as we write and pass very important legislation to reauthorize the CFTC.

I would now turn to Senator Cochran.

STATEMENT OF HON. THAD COCHRAN, U.S. SENATOR FROM THE STATE OF MISSISSIPPI

Senator COCHRAN. Madam Chair, it is a pleasure to join you and the other members of the Committee in reviewing the statements of the witnesses who are here to testify before our Committee today. The Commodity Futures Trading Commission reauthorization is before the Committee for review as we evaluate recommendations for modifications or improvements, and that is what I hope the witnesses can share with us today in terms of their views and their ideas for any changes in the law that need to be considered by the Committee.

We have others who are here today to hear from the witnesses, and the witnesses themselves, so I am pleased to join you in welcoming all of them, and thank them for their cooperation with our Committee.

Chairwoman STABENOW. Thank you very much, and welcome again. We have two excellent panels, and we appreciate your time today.

Senator CHAMBLISS. Madam Chair?

Chairwoman STABENOW. Yes, Senator Chambliss.

Senator CHAMBLISS. Could I ask unanimous consent that a very brief statement I have be inserted in the record?

Chairwoman STABENOW. Absolutely. Without objection, and that reminds me to also indicate that we are happy to accept opening statements from any of the members of the Committee. In the interest of time, because we have two large panels, we will move forward, but we certainly want to receive any statements from members.

[The prepared statement of Hon. Saxby Chambliss can be found on page 50 in the appendix.]

Chairwoman STABENOW. And, of course, as you all know, we will ask for 5 minutes in testimony, but, of course, we want whatever you would like to give us in terms of written testimony. So let me introduce the full panel, and then we will ask for 5 minutes in opening statements.

First we have the Honorable Ken Bentsen, president of the Securities Industry and Financial Markets Association. From 1995 to 2003, he served as a Member of the U.S. House of Representatives from Texas. Several of us served with you. It is wonderful to see you again. He sat on the House Financial Services Committee, and was an active participant in the drafting of the Commodity Futures Modernization Act.

Our second witness is also no stranger to this Committee or the markets: Mr. Terry Duffy, executive Chairman and president of the CME Group. Mr. Duffy has been a member of CME since 1981. Also, in 2003, he was appointed by President Bush as a member of the Federal Retirement Thrift Investment Board. Welcome.

Next is Mr. Adam Cooper, someone who we have also appreciated coming before the Committee before, senior managing director and chief legal officer at Citadel LLC in Chicago, where he is responsible for Citadel's legal compliance and regulatory affairs functions. He is here today on behalf of the Managed Funds Association, an organization he knows well, having served two terms as chairman, and I also have to always say he is a proud graduate of the University of Michigan. So we know you know what you are talking about.

Our fourth witness is Mr. Dennis Kelleher, who also knows the Senate well, as a distinguished staffer for many, many years. He is President and CEO of Better Markets. Previously Mr. Kelleher served as a litigation partner with Skadden Arps specializing in securities and financial markets, and it is great to see you.

Mr. Roth, it is wonderful to have you back as well. Dan Roth is the president and CEO of the National Futures Association, where he has been since 1983. Prior to joining NFA, Mr. Roth was an attorney focused on general litigation and an assistant attorney general in Cook County, Illinois.

Thank you very much for joining us, and we will start with Congressman Bentsen.

STATEMENT OF THE HONORABLE KENNETH E. BENTSEN JR., PRESIDENT, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, WASHINGTON, DC

Mr. BENTSEN. Thank you, Chairwoman Stabenow, Ranking Member Cochran, and members of the Committee. I appreciate the opportunity to testify on behalf of the Securities Industry and Financial Markets Association on the reauthorization of the CFTC.

Title VII, as you know, of the Dodd-Frank Act created a broad new regulatory regime for derivative products and seeks to reduce systemic risk by mandating central clearing, capital requirements, collection of margin for uncleared swaps; to protect customers through enhanced collateral safeguards and external business conduct requirements; and to promote transparency through reporting requirements, new business conduct rules, and required trading of swaps on exchanges or swap execution facilities.

SIFMA supports many of the goals of Dodd-Frank's Title VII. However, we remain concerned that regulators, especially the CFTC, are interpreting and implementing many of these provisions—or how they are interpreting and implementing many of these provisions. I would like to highlight several issues that we would like to see addressed in the CEA reauthorization which we think will have a profound effect on the success of Title VII and the marketplace.

With respect to cross-border treatment of swaps, Section 722 of Dodd-Frank limits the CFTC's jurisdiction over swap transactions outside the United States to those that "have a direct and significant connection with activities in, or effect on, commerce of the United States" or are meant to evade Dodd-Frank. In seeking to clarify its jurisdiction, on July 12th, the CFTC voted to approve final cross-border guidance, as well as a phase-in exemptive order.

First and foremost, we believe it to be imperative that the CFTC, SEC, and global regulators coordinate their work on implementing OTC derivatives regulatory reform in furtherance of the G–20 commitments. We believe that the international nature of the swaps market makes such global coordination, in addition to domestic coordination, critical in order to achieve an appropriate level of oversight of swaps activities and further help to avoid unnecessary market disruption.

While it is a little too early to get a full read of the guidance and exemptive order that were put out, because they just—actually we are in the third round of the exemptive order and still going through the guidance that was put out yesterday. We believe and we hope that it moves towards better coordination, but we believe that the Committee in the CEA should take a look at how we can streamline and enhance that coordination particularly among the CFTC and the SEC.

In addition, I would like to talk about the Swap Push-Out Rule, Section 716 of Dodd-Frank. This is a provision that was added in this body but not really debated in the normal process through the other body and something that the prudential regulators in particular that the then-Chairman of the FDIC, Sheila Bair, and the current Chair of the Federal Reserve Board, Ben Bernanke, argued against, believing that it would affect their ability to prudentially regulate banks where swaps activities take place. And we would encourage the Committee to consider inclusion of bicameral legislation that has been introduced by Senators Johanns, Hagan, Toomey, and Warner, S. 474, that would amend this provision. I would note that the regulators have already forestalled its implementation, and so clearly they are struggling with this provision as well.

Likewise, with respect to swap execution facilities, this is a situation where the CFTC and the SEC have gone in different directions. The CFTC, in their rule that was finalized earlier this year, came out with a rule that we think does not fit with where the marketplace is, and particularly from our asset manager members who are very concerned about the minimum mandatory Request for Quote model that is imposed by the CFTC's final rule, and our view from our asset manager standpoint is that this rule will actual be counterproductive and end up costing asset managers clients who utilize the swaps markets for the benefit of their investors, their fund holders, and the like. And this is an area where, like the House has adopted on a couple of occasions, that the Committee should look at going back and making further clarification on how SEFs are treated.

Finally, I would raise with the Committee a provision in the Basel III company standards which were recently adopted by the Federal Reserve Board and interimly adopted by the FDIC. And, in particular, it has to do with the credit valuation adjustment. This is a provision that addresses capital put against by the dealer on swaps with non-financial counterparties. In Europe, under the European Union, they have taken a different approach because of problems in how CBA was developed by the Basel Committee, and this results, in our view, in a fragmentation between the U.S. and the EU, and it is something that we think that the Committee and perhaps the FSOC should take a look at. So we would encourage the Committee to take a look at that.

With that, I will yield back the balance of my time.

[The prepared statement of Mr. Bentsen can be found on page 54 in the appendix.]

Chairwoman STABENOW. Thank you very much.

I would ask other witnesses to take notice, a former Congressman made it within 2 seconds of 5 minutes. That was very good.

Mr. Duffy, welcome back.

STATEMENT OF TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN AND PRESIDENT, CME GROUP INC., CHICAGO, ILLINOIS

Mr. DUFFY. Thank you. Good afternoon, Chairwoman Stabenow, Ranking Member Cochran, and Committee members. I want to thank you for the opportunity to testify today regarding the reauthorization of the CFTC.

Dodd-Frank subjected the unregulated, opaque OTC swaps market to a new regulatory regime based largely on the successful model for futures exchanges and clearinghouses. The CFTC was granted power to adopt regulations to implement this new model.

While the Commission and the staff are to be commended for their efforts to fix the swaps market, the Commission rules have often gone far beyond Congress' intent. In some instances, the Commission has implemented Dodd-Frank by uncoordinated and inflexible rules that would have brought the industry to a standstill absent several last-minute no-action relief letters.

The Commission used its swap mandate as a pretext to impose needless rules on the robustly regulated futures market. Congress did not intend to rewrite the rules of this well-functioning, highly regulated marketplace.

As the CFTC contemplates its remaining rules to implement Dodd-Frank, we encourage the Committee to ensure that these rules remain within the congressional mandate and do not undermine the ability of business in the United States and worldwide to continue to manage risk.

The agency's initial proposal to impose its rules across international borders without regard to local rules or regulations had threatened to expose the industry to conflicting duties and set the stage for retaliation from foreign regulators. We welcome last week's agreement between the CFTC and the European Commission on a "Common Path Forward." We are hopeful that this positive development will lead to the U.S. and EU regulators achieving workable mutual recognition of derivatives trading and clearing regulation.

Customer protection was noted in many responses the Committee received on reauthorization. Customer protection and market confidence are the cornerstones of CME's business. Since the failure of MF Global and Peregrine, CME and others have implemented numerous rules to strengthen and protect the customer protection of futures commission merchants. For example, daily access to aggregated customer balances of banks facilitates our risk-based reviews of FCMs.

The CFTC has proposed rules that codify these initiatives, which we support. However, we urge the CFTC to reject other proposed requirements such as the residual interest proposal. That would likely drive out smaller FCMs that serve the agricultural community out of business in this country.

It is also essential for customer protection and healthy U.S. derivatives markets that the agency which oversees us be adequately funded. But we strongly oppose the administration's proposal to fund any of the proposed $315 million of the CFTC's budget with a transaction tax. Such a tax will substantially increase the cost of market making, an essential source of market liquidity, as well as business costs for all customers, even those the administration wants to exempt. It will reduce liquidity, increase volatility, and impair efficiency-raising hedging costs for farmers, ranchers, and other commercials which will be passed on to consumers in the form of higher prices for food and other goods.

Unexpected funding may be collected when volumes drop because market participants are driven out of U.S. markets. Last week, regulators in India saw derivatives volume drop by more than a third immediately following implementation of a 1-percent transaction tax.

These are just a few of the many issues that have been submitted to the Committee in connection with your consideration of CFTC reauthorization. We stand ready to be a resource to the Committee on these and other critical issues to the futures and derivatives marketplace.

I want to thank you for your time and attention, and I look forward to answering any questions you may have.

[The prepared statement of Mr. Duffy can be found on page 81 in the appendix.]

Chairwoman STABENOW. Thank you very much. Mr. Cooper, welcome.

STATEMENT OF ADAM COOPER, SENIOR MANAGING DIRECTOR AND CHIEF LEGAL OFFICER, CITADEL LLC, CHICAGO, ILLINOIS, ON BEHALF OF MANAGED FUNDS ASSOCIATION

Mr. COOPER. Thank you very much, Chairwoman Stabenow, Ranking Member Cochran, members of the Committee. My name is Adam Cooper. I am senior managing director and chief legal officer of Citadel LLC. Citadel is a financial institution that engages in a wide range of asset management and capital markets activities on a global basis. I am here today on behalf of Managed Funds Association and its members, and I am pleased to provide testimony at today's hearing on reauthorization of the CFTC.

MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices for the alternative investment industry. As fiduciaries to our investors and as customers ourselves, we share with members of this Committee a keen interest in ensuring that applicable rules provide a strong framework for the market and its participants. Though we have made progress since the financial crisis, there is much still to be done. I would like to highlight a few points in this regard.

First, protection of customer collateral. MFA has been a vocal and consistent advocate for central clearance of derivatives transactions. Getting clearing right entails many complex, legal, and operational issues. One important element is the framework for protecting the property of customers who clear swaps through FCMs. Here the CFTC has chosen LSOC, a model which provides an additional level of customer protection over other models. We believe, however, that Congress could enhance the customer protections that LSOC and other models would provide.

Specifically, amendments to Chapter 7 of the Bankruptcy Code could ensure that, upon an FCM's insolvency, customer assets posted as collateral on cleared swaps would not be subject to pro rata distribution.

Moving on to CPO registration, the Dodd-Frank Act and CFTC rulemakings have broadened the regulatory framework to include many entities that were not formerly subject to CFTC regulation. MFA has been consistent in supporting elimination of gaps in regulation. However, the repeal of CFTC Regulation 4.13(a)(4) extends the regulatory umbrella more broadly than is necessary. This creates a very real risk of scarce resources being spread too thin at a time when we need our regulators to focus on the mission at hand. We urge the Committee to examine this issue in detail.

Turning next to CFTC and SEC coordination, the CFTC and the SEC have stepped up their cooperation in recent years, and all market participants have been the better for it. But much work remains to be done.

For example, last week, the SEC adopted rules under the JOBS Act to eliminate the ban on general solicitation for certain private placements. The CFTC's regulations were drafted a number of years ago to be consistent with the SEC's rules on private placements. We believe it is now time for the CFTC to adopt complementary rules to effect Congress' intent under the JOBS Act.

The many systemic risk filing requirements required under Dodd-Frank represent further examples where greater coordination is needed. Currently an entity that is registered with both the CFTC and the SEC face up to three different filing requirements, that is, with the SEC, the CFTC, and the NFA. We recognize and support that regulators must have the information that they need, but steps must be taken to reduce unnecessary and costly burdens resulting from duplicative requirements.

Moving on to confidentiality, MFA has supported congressional and regulatory efforts to increase the flow of information to regulators. We appreciate the need for regulators to be well informed. Yet it is of paramount importance that our laws require regulators to take all steps necessary to preserve the confidentiality of that information and, further, that robust protections exist with respect to the sensitive and proprietary intellectual capital of asset managers. Today a fund manager filing a document with the SEC has greater legal certainty of the confidentiality than if that manager filed the very same document with the CFTC. We believe the CEA should be amended to provide the same protections to CFTC registrants as the Advisers Act provides to investment advisers.

Finally, international cooperation. MFA members engage in financial transactions in virtually every market around the globe. We are supportive of thoughtful regulations to ensure market integrity and to provide a dependable legal infrastructure in which to trade. But ensuring a well-functioning global market depends on coordination among regulators. It is simply unworkable to operate in an environment in which different jurisdictions have conflicting or overlapping rules. Market participants need to know which rules apply and under what circumstances, and those rules should make sense and reflect the economic realities of the transactions.

MFA believes the recent efforts of the CFTC and the European Commission to address cross-border issues is a positive step, and we are hopeful that these efforts will lead to a workable framework. We urge this Committee to continue to exercise its leadership in oversight of these types of international agreements as they occur in the future.

My written statement outlines these points as well as others in greater detail. I appreciate the opportunity for you to consider my views and am available to answer questions. Thank you.

[The prepared statement of Mr. Cooper can be found on page 68 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Mr. Kelleher.

STATEMENT OF DENNIS M. KELLEHER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BETTER MARKETS, INC., WASHINGTON, DC

Mr. KELLEHER. Good afternoon, Chairman Stabenow, Ranking Member Cochran, and members of the Committee. Thank you for the invitation to Better Markets to testify today.

Better Markets is an independent, nonprofit, nonpartisan organization that promotes the public interest in the domestic and global financial markets. I have detailed what Better Markets does in my written testimony. It is also available on our website, bettermarkets.com, and I will not repeat that here.

I would like to say it is a privilege and honor to return to the Senate to testify after having been a staffer for three different Senators over the years and having worked with many of you during that time.

I would like to make a few very quick points.

First, the financial crash and its cost. Everyone likes to talk about the 3-year anniversary of the Dodd-Frank financial reform law, but too few even mention that just 5 years ago, the U.S. suffered the worst financial crash since 1929, which inflicted the worst economy on the United States since the Great Depression. Only massive taxpayer and Government bailouts prevented the total collapse of the financial system and a second Great Depression. As the Chairwoman noted at the beginning, the American people paid and are still paying a very high price for that, including slow to no growth, persistently high unemployment, tens of millions of homes underwater, massive deficits, unprecedented Fed policies like zero interest rates and trillions in bond purchases, among so much more economic wreckage across our country. Ultimately that is going to cost the United States more than $12.8 trillion, as you all know, from many of the damages inflicted on your constituents.

As is well known, unregulated, non-transparent over-the-counter derivatives markets were at the heart of causing and spreading those financial and economic crises and costs, and that is why derivatives regulation is vital to effective financial reform as well as the protection of the American people, taxpayers, our Treasury, and our financial system.

Second, the Committee should avoid becoming another battleground in the war over financial reform and should not relitigate Dodd-Frank. The responsibility for the CFTC was dramatically expanded from the $37 trillion notional futures market to include the $340 trillion notional U.S. swaps market. That was a monumental, transformative change for the agency and the markets where there are trillions of dollars at stake.

It was inevitable and no one should be surprised that whatever the CFTC did, it was going to be highly controversial and hotly contested and, unfortunately, recontested. Yet the least funded, smallest financial regulatory agency, the CFTC, has taken the new laws and mandates seriously and done an outstanding job of translating the financial reform law into a reality. They have not done a perfect job, and we have not agreed with all that they have done. No one has. But that does not mean the new law should be changed on a piecemeal basis, especially given that they are now just finalizing most of their rules and few have even been implemented.

The complaints being raised are almost entirely speculative and from special interests seeking to advance their narrow self-interest. That is their right. But it is no basis to start changing laws and public policy prematurely.

Given the historic changes being put in place, the CFTC should be allowed time to implement the rules, see how they work, determine if changes should be made, and given the opportunity to make them. That would be the appropriate time for considering whether statutory changes are necessary or appropriate. Now is not the time and reauthorization is not the place. I urge you not to let this Committee become the latest battle front in the war over financial reform.

Third, the CFTC is woefully underfunded and simply cannot do the job Congress asked it to do and the job that the markets and investors desperately need it to do. I have detailed in my testimony those details and will only say that an agency with $200 or even $300 million in annual budget cannot properly regulate or oversee the futures and swaps markets with almost $400 trillion in notional trading. The CFTC has to have the authority to impose fees and be self-funded in whole or in substantial part. If not, it is being set up for failure. It is being asked to do so much that is so important without the resources it needs to get the job done. That will be a gross disservice not just to investors but to market participants themselves.

Fourth, and last, the industry claims for so-called innocent-sounding cost/benefit analysis is, in fact, little more than industry-cost-only analysis, and it must be seen for what they are most of the time: a back-door attempt to kill or gut financial reform. The proposals will impose onerous, costly requirements. Calls for cost/benefit analysis sound good in theory, but they are often catastrophic in reality for the public interest. The CFTC has done economic analysis for decades as required by the CEA. Tellingly, there have been few, if any, complaints about their work until it began implementing financial reform. That tells everybody what is really going on here.

Thank you, and I look forward to your questions.

[The prepared statement of Mr. Kelleher can be found on page 121 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Mr. Roth.

STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, ILLINOIS

Mr. ROTH. Thank you, Senator. As this Committee begins the reauthorization process, it is entirely appropriate that your attention and all of our attention is focused on customer protection issues.

For the longest time, the futures industry had a very well deserved impeccable reputation for safeguarding the integrity of customer funds. But twice in the last 18 months, first at MF Global and then at Peregrine, that reputation took a serious hit as customers suffered very painful losses, and losses that, frankly, we as regulators are supposed to prevent.

Clearly some dramatic improvements were required, and over the last 18 months we have worked very, very closely with the CFTC and with the CME and other SROs to bring about those changes, and I have detailed those in my written testimony, but I would like to highlight a couple of them in my oral remarks.

First, the heart of the matter really is the protection of customer segregated funds. And for years and years, we have required FCMs to file daily statements with NFA regarding the amount of customer funds that they are holding, and we analyze those statements and look for trends. But we confirmed those balances to outside sources in the past only as part of our annual examination. When we would go out and do an examination of an FCM, we would then confirm those balances to outside sources such as the banks actually holding the customer funds. And when we did that, we did it through a paper confirmation process where we would mail a confirmation request to the bank and then the bank responded directly to NFA, again, in writing.

In 2012, we switched to an electronic confirmation process, and it was that e-confirmation process that uncovered the fraud at Peregrine. But even then it was still just part of the annual examination, and we felt we needed to do a much better job, and that is what we have done. Together with the CME, we have built a system now where we have daily confirmation of all seg bank balances so that we still receive reports daily from the FCMs regarding the amount of funds they are holding, but now for over 2,000 bank accounts that are holding customer segregated funds, we also receive a confirmation from the bank. We then perform an automated comparison between what the firm is saying and what the bank is saying to identify any suspicious discrepancies. This is a huge improvement from where we were just a year ago. And although it is a big improvement, it is certainly not the only one that we have done.

Again, as I have detailed in my testimony, we have increased dramatically FCM financial transparency. We have created a situation in which customers can come to the NFA website and there they can find financial data on all FCMs, key financial data both current and historical, so that they can do their due diligence, and that information includes information on how the FCM is investing customer funds.

We have set stringent requirements for FCMs regarding minimum internal controls. We have adopted additional safeguards to prevent the misuse of customer segregated funds. We have had a top-to-bottom outside examination of all of our examination and audit practices, and we are adopting the improvements that were suggested.

I would like to stress that on each one of those items, each one of those improvements, we worked very closely with the CFTC, and we were very gratified when the CFTC came out with its rule proposals that so much of the CFTC's proposal was really adopting the changes that we had already made.

So a lot has been done, but there is always more to do, and two items in particular that I would like to mention. One, I think both the Peregrine and the MF Global situations highlighted certain issues regarding FCM insolvencies and bankruptcies. And those are very complicated issues. We are working with every facet of the industry to try to find common ground on proposals that everyone can agree to. But I can tell you, our primary focus is to ensure that an FCM insolvency, if there is a shortfall in customer segregated funds, then customers receive the top priority. That, in our view, is the right result. That is the result that is called for under CFTC rules, and that is the result we want to ensure is always achieved in a bankruptcy.

With respect to customer account insurance, both MF Global and Peregrine have renewed questions about whether we should have customer account insurance. That is a very serious question. It deserves a serious debate, and there are a lot of public policy issues involved. But you cannot have any rational debate on that issue, I do not think, until you first know what kind of insurance would we be buying and what are we going to pay for it. That may not be the endpoint of the discussion, but it is an essential starting point. And you cannot answer that question, frankly, unless you have cold, hard data and a lot of it, because you have got to go to the insurance companies and provide them with detailed, granular information so they can perform an actuarial analysis and determine their risk.

We are working on that study with the FIA, with CME, and with the Institute for Financial Markets. That is well in progress, and we hope to have it completed in the next few weeks, hopefully by mid-September.

I am sorry I went over my limit by 15 second at this point, but we look forward to working with Congress and the industry, and I would be happy to answer any of your questions.

[The prepared statement of Mr. Roth can be found on page 157 in the appendix.]

Chairwoman STABENOW. Thank you very much, Mr. Roth. And that is all right. We had some time that others gave up on your behalf here.

Thank you to each of you. Obviously we have a lot of questions. There are a lot of things we could cover, and in the limited time in each of us asking 5 minutes of questions, I would ask just that you be as concise as you can, because we have got a lot of ground to cover.

When we look overall at so many different issues, the challenge for the CFTC really does relate them having the resources, the staff, the ability to do all that needs to be done in terms of accountability. There is a whole range of things that need to happen. But I want to start with the issue around resources because it is fundamental. It is not something that is just a side issue in terms of their being able to function.

Mr. Duffy, you talked about the importance of adequate funding for the CFTC. At the same time, I know that you are opposed to user fees. And so what other options would you suggest for us as an alternative means of funding the agency. The SEC, other regulatory agencies have funding streams. CFTC does not. That is a serious impediment as we go forward and hold them accountable for decisions they make and the oversight that they have. So what would you suggest?

Mr. DUFFY. Well, it is difficult for me to come up with a suggestion for the Government, but I will say a couple different things.

When we talk about liquidity and what the costs could be to the American consumer if a small fee or transaction tax was imposed on the market maker liquidity pools, even though the pool—some of it has been exempt, it could be extraordinary. I gave you a quick example of what happened in India when a third of their market makers went away. When the market makers go away, Senator, the bid-offer goes wider. When a bid-offer goes wider, the cost of business goes up. When the cost of business goes up, it gets passed on to the consumers.

If you want to find a quick way to make $315 million with a transaction tax, it will cost you $1.5 billion to do it. So that is not a smart thing to do.

Chairwoman STABENOW. So the question is, What? I mean, I appreciate—I have heard that concern that——

Mr. DUFFY. It is hard to say what is the concern, but I think we have to make sure—no disrespect to Mr. Kelleher, and I am not going to, but when we talk about $400 trillion of over-the-counter derivatives that the CFTC is going to be regulating, you have to realize that those $400 trillion is about 2,000 transactions. We do not weigh the money. You know, we do not have to say, it can cost a lot more to do this. It does not matter what the notional value is. It is about the transaction volume that is associated with it. Our world today does 20 million transactions a day.

Chairwoman STABENOW. No, I appreciate that. I guess what I am asking——

Mr. DUFFY. So there is a big difference——

Chairwoman STABENOW. We have a seriously underfunded agency that has seen about——

Mr. DUFFY. You know, it is hard for me to stand up here——

Chairwoman STABENOW. —a significant increase in their responsibilities.

Mr. DUFFY. —and say that, you know, it benefits the taxpayer by paying the $305 million. But the reality is, ma'am, it benefits the taxpayer by paying the $305 million to fund the CFTC, because in return the risk management that is associated with it goes from farmers to reinsurers to small bankers is a cost that is immeasurable.

Chairwoman STABENOW. So you are saying basically taxpayer funded.

Mr. DUFFY. That is the way it has been funded for years, yes, ma'am.

Chairwoman STABENOW. Mr. Roth, the National Futures Association is self-funded with members' fees, dues, assessments. Have those fees been prohibitive in terms of expense to the industry? Have they impacted the markets negatively?

Mr. ROTH. Let me make a couple of points on that, Senator.

First of all, we have a number of different regulatory spheres. We have futures compliance, now swaps compliance. We also have a market surveillance function we perform for certain contract markets and soon SEFs. And we oversee retail foreign exchange transactions that are off exchange. We try to make sure that each regulatory sector pays its own freight, that they carry their own weight. Most of it, for most of those sectors, that is done through membership dues.

With respect to the futures activity, we do have an assessment fee that is imposed on trades and collected by FCMs, but I should point out that at the very outset when they were forming NFA, they were very careful and worried about taxing liquidity out of the market. So our fee has a very particular structure to it, so that our assessment fee does not apply to any trade that is conducted by a member of the contract market where the transaction is executed. So, really, we only assess—about, oh, 22, 23, 24 percent of the overall trading volume is subject to our assessment fee, and it was structured that way specifically to avoid taxing liquidity out of the market.

Chairwoman STABENOW. Thank you very much.

Mr. Cooper, you talked about the need for consequences for breach of data security, a very serious issue, and I am wondering what sort of consequences would be appropriate. There is a proposal, broadly supported an indemnification provision from the Dodd-Frank Act. Would removing the provision harm data security? Or are there other ways to protect confidential data?

Mr. COOPER. I do not think removing that provision would harm or risk confidentiality. That actually would enhance the flow of information to necessary parties.

The consequence is accountability. We need to make sure that there are robust requirements imposed on the various regulators for this huge volume of information that is now flowing into them. We need to make sure that there are no asymmetries between the confidential protections afforded to a market participant giving information to one regulatory agency versus another. We need to synthesize and harmonize, in other words, the protections available between the CFTC and the SEC.

Chairwoman STABENOW. Thanks very much. I have many more questions, and we will be following up with all of you, but I am going to turn now to my Ranking Member, Senator Cochran.

Senator COCHRAN. Thank you, Madam Chair, and we appreciate all of the witnesses being here today to help us understand what the options are and what the appropriate action could be in helping to protect those who use the services of the markets to hedge and to protect themselves from marketing disasters as well as weather-related disasters that can make it very difficult in our economy.

I wonder, for example, though, if some of the things that you end up hearing as suggestions for change or improvements or modernization might do more harm than good. You might just glance through some of the suggestions that we have already received and tell us, "It is okay to consider this but please do not do it because it is going to be creating a problem that is bigger than the one that we already have." That may be a negative way to ask a question, but, Mr. Duffy, I would just ask you, could you take a shot at that and warn us against doing something that we might be talked into doing that really has a negative effect on the situation?

Mr. DUFFY. You know, Senator, I am a fairly firm believer that a one-line reauthorization is exactly what the industry needs right now. We do not need any additional burdens or changes. I think the industry has come light years in the last 10 years. Mr. Roth just gave you an example what we did in the last year alone. I think the industry has benefited immensely because of the things that we have done internally, and I would hope very much that Congress would take that into consideration and just go ahead and do a one-line reauthorization and not make too many changes.

I think there are some menus or exemptions that I am sure some of my colleagues would like to see on behalf of their clients, and I would not be opposed to that. But I think overall less is better.

Senator COCHRAN. Thank you.

Thank you, Madam Chair.

Chairwoman STABENOW. Thank you very much.

Senator Brown.

Senator BROWN. Thank you. Mr. Duffy, I am intrigued, actually by your assertion perhaps of a one-line bill, what that might mean for the ability of—or taking away the ability of certain interest groups to make mischief in this derivatives market.

Thank you, Mr. Kelleher, for your comments and reminder of what this hearing is all about, what reauthorization is all about, what this agency is all about, and your discussion of costs and benefits. There are costs to industry in much of this throughout the regulatory apparatus, but we know what the cost to society was, the cost to society was because we did not do some things we should have done 5 years ago, 10 years ago.

Congressman Bentsen, nice to see you. I appreciated your comments about Dodd-Frank's Push-Out Rule, which requires banks with access to deposit insurance and the Fed's discount window to move derivatives trades to separately capitalize affiliates.

My first question is for Mr. Kelleher. Despite the lessons learned from the financial crisis, the markets experienced, as we know, several significant disturbances, most recently last year's $6 billion London Whale trading losses. Such incidents should serve as a reminder that the rules are there to make banking—supposedly to make banking safer, not riskier. Give us your thoughts on the push-out provision, whether it is making our system safer or riskier. What are your concerns about proposed legislation to roll back this provision?

Mr. KELLEHER. Thank you, Senator. It seems to me that at the level of the purpose of the swap push-out provision, nobody can really disagree, which is that the entities, large entities engaged in high-risk and non-hedging trading put those activities in a separately capitalized subsidiary, which will not otherwise have access to taxpayer bailouts or the Fed window. That seems to me that everybody would agree on.

Then the question becomes—and it came up during the—as many of you know, not just during the consideration but during the conference, and indeed, some of the statements made about the objections to the swaps push-out provision were actually made in April and May of 2010, prior to the conference, prior to the fix to this provision, which allowed commercial banks to engage in a variety of traditional activities, including, importantly, allowing hedging. So it was changed in conference.

So some of the testimony that has been provided to you in writing actually cites objections to that provision that are inapplicable since it was put into law.

So the swaps push-out provision is very important so that the non-hedging, non-traditional commercial banking activities in the derivatives market are in a separate subsidiary, separately capitalized, so that it does not take down the bank itself and does not end up with more taxpayer bailouts and access to the Fed window.

Senator BROWN. Thank you. Let me shift, Mr. Kelleher, to a different issue. I am concerned about the risks associated with banks' expanded business operations into physical commodity, energy, commercial business operations, warehousing, transportation, leasing, distributing commodities, one notable one in Chairwoman Stabenow's State.

In a Reuters story, a trader said, and I want to quote: "The truth of it is that having access to the physical markets is about optimization and knowledge. It gives the trader the visibility of the market to make far more successful proprietary trading decisions in both physical and financial markets. It is trading with material non-public information." He then goes on to say, "The difference compared with equity markets is that it is perfectly legal."

Mr. Kelleher, talk, if you would, about the potential or existing conflicts in market risks that arise from banks engaging in commodity and energy and commercial business operations, what it means for consumers, what it means for businesses that use those commodities.

Mr. KELLEHER. Well, I think it is clear that consumers and end users are getting squeezed in paying the price for the biggest banks in the country, moving into, in massive amounts, physical commodity storage and trading activities while at the same time they are engaging in the futures market and in the swaps market, and they have direct or indirect, partial or significant ownership in some of the exchanges.

Now, the LME in London has changed that in the last 2 years, but what we have seen lately—and there has been some reporting in the last several days about the warehousing of aluminum and how companies from Coca-Cola to Coors to beer companies to, you know, auto manufacturers are getting squeezed and paying a fortune because there are bottlenecks that appear to be created for the purpose of generating cash for the banks at the expense of the end users and other market participants.

So the conflicts of interest should be looked at really closely. We do not even have the data on it, and one of the things we suggest that the Committee does in reauthorization is get the CFTC authority to get this data so they can see what is happening in the physical markets by these banks, at the same time they can see what they are doing in the futures and swap markets. And then we will have a much better picture of the conflicts of interest.

Senator BROWN. Thank you.

Thank you, Madam Chair.

Chairwoman STABENOW. Thank you very much.

Senator Roberts.

Senator ROBERTS. Thank you, Chairwoman Stabenow and Ranking Member Cochran, for organizing this hearing and beginning the important process of reauthorization.

This Committee's oversight of the CFTC is not taken lightly by any member, especially in light of the failures of MF Global and Peregrine. We are limited on time, and that is always the case here. I wish we had more time with the expert panelists, especially covering a range of topics. So I would like to ask at least some of the panelists answer in a yes or no fashion. I know that is difficult—these are very difficult for yes or no answers—and that it is not fair. But life is not fair.

Representative Bentsen, good to see you, sir. As the CFTC works to implement the Dodd-Frank Act, there have been more than a few bumps in the road resulting in numerous no-action letters, exemptive relief, and enforcement delays. I am worried about certainty.

Before proposing rulemaking or guidance, does the CFTC routinely conduct enough quantitative analysis regarding the costs and benefits of their regulations, in your opinion?

Mr. BENTSEN. No, Senator.

Senator ROBERTS. For the cross-border application of derivatives regulation, should the CFTC have used a formal rulemaking process, including a cost/benefit analysis, instead of issuing the regulations through "an interpretive guidance and policy statement"? Which, by the way, is over 300 pages long?

Mr. BENTSEN. Yes.

Senator ROBERTS. Mr. Duffy, when Chairman Gensler was in front of this Committee in February, he was surprised by the pushback against their proposed rules on margin requirements. Has the CFTC taken the correct approach for customer protection by requiring a futures commission merchant, FCM, to have their customers meet margin deficiency at all times?

Mr. DUFFY. Has the Commission made sure that they meet it at all times?

Senator ROBERTS. That is correct.

Mr. DUFFY. The exchanges do set the margins, and——

Senator ROBERTS. Just do not worry about it. Just say, "No."

[Laughter.]

Mr. DUFFY. Yes, sir. No.

Senator ROBERTS. If left unchanged, will this requirement have a significant and negative impact on the agricultural sector of the market?

Mr. DUFFY. It could, yes.

Senator ROBERTS. Has the CFTC relied too often on no-action letters, exemptive relief during the implementation of Dodd-Frank, creating confusion and uncertainty in the marketplace?

Mr. DUFFY. Without question, yes.

Senator ROBERTS. Mr. Cooper, internationally—and I emphasize "internationally"—the CFTC is working to implement final guidance on cross-border swaps and released their latest action late as of last week, notwithstanding the progress—and I give every credit in that regard—with the CFTC. I do have a lot of concerns with the CFTC trying to enforce regulations worldwide let alone imposing their regulations on all of our trading partners.

For the scope and framework of international derivative regulations, are you concerned that there could be a patchwork of different regulations if the CFTC does not do a better job of harmonizing, not dictating, their efforts with their foreign partners? So, put another way, is it more important to get our regulations correct or, even better, in line with our counterparts across the world?

Mr. COOPER. We certainly need certainty, we need consistency and harmonization, and certainty was provided in certain important respects by the CFTC's action with respect to the definition of "U.S. person."

Senator ROBERTS. So your answer is yes. Is that correct?

Mr. COOPER. Yes.

Senator ROBERTS. Thank you. For once in my time on the Committee, House or Senate, I am yielding back a minute and 2 seconds.

Chairwoman STABENOW. I think we should make a special note of this in the record. It is the first time for Senator Roberts.

Senator Gillibrand is next. I do not see her at the moment, so, Senator Heitkamp.

Senator HEITKAMP. Thank you so much, Chairwoman and Ranking Member, for pulling together this very important panel and these experts.

I want to focus, I think, on just a couple issues, but not to belabor the point, but if you think that MF Global had impact globally and across the country, I can tell you that people in North Dakota were shocked, absolutely shocked, because it moved off the agricultural pages into the front page, talking about the risk that now our farmers and our producers thought was completely impossible to have incurred the loss. And most of them have recovered about 89 percent of their money. They are still waiting for the other 11 percent. And they wonder why people do not go to jail, and they wonder why this and how this could possibly happen in America when we have, in their opinion, one of the most regulated industries and regulated environments in the world.

I am not here to point fingers or to assess blame. I am looking for solutions, and I am looking for a path forward. And, Mr. Duffy, I notice in your testimony, although not covered in your comments, is a discussion about insurance. And this has been a topic of many of the people who have come to visit me recently about potential expansions of products that could, in fact, mitigate risk.

You mentioned that there is pending a Futures Industry Association study. Can you tell me when that study is going to be done? And can you give me any kind of preliminary insight on whether you personally, given your experience, believe that an insurance market could be created that would be helpful to mitigate risk?

Mr. DUFFY. Sure. Thank you, Senator. I think Mr. Roth also is involved in that study, and we are looking to have completion on that sometime in mid-September. So, you know, we have put a lot into the study, so we are both looking forward to the outcome of that information.

Secondly, on the MF Global clients, this has been a very horrific incident in our industry, and people are wondering if somebody is going to go to jail. There is no question about it has been on the front pages. You know, you could put a cop on every street, as they say, and someone is still going to try to commit a murder.

With respect to the monies, there is 99 cents on the dollar returned to all the 4d clients of MF Global. 4d clients are U.S. participants trading on regulated exchanges. They have 99 cents on the dollar. And then for 30.7 clients of MF Global, they have 97 cents on the dollar. Those are U.S. participants trading on a foreign exchange. So most of the people, the good people of North Dakota, should have 99 cents on the dollar back of their money. The people that had their money in a broker-dealer is a different story. That is an unregulated business, so that is maybe the number that you are referencing, ma'am.

On the insurance itself, I have not been really a big proponent of insurance, but I do believe that if the participants want it, we should offer it. And I have no problem with that. We have a fund at the CME Group, as you may or may not know, that is called the "Family Farmer and Rancher Fund." It is a self-insured, $100 million fund that we use to make sure if there is fraud or something like that, we will pay up to $100 million to these participants in total.

I could not insure that fund without any major insurance company around the world. We have $158 billion of segregated funds in our world today. I do not know what the cost of that would be to insure. I think if people want to pay the premium for that insurance, they should have every right to do so. That is my personal viewpoint. I do not believe it should be legislated. I think this business will be crushed overnight if you legislate that type of insurance into the marketplace.

So I think the optionality should certainly be there, and the FCMs should offer it up, and the exchanges and the other SROs should help the FCMs in facilitating that procedure.

Senator HEITKAMP. And not to belabor the point, but I think it is going to be extraordinarily difficult to see a product like that develop that is useful in the private sector. There is a reason why we have flood insurance; there is a reason why we have crop insurance. There is a reason why there is often a backstop that the taxpayers assume some of the risk going forward.

I want to just spend a little bit of time talking about bankruptcy, because one of the issues obviously is a failure, even though it seems clear to me that when you have customer accounts that they ought to be the first ones out in a bankruptcy, I am a lawyer, I do not know why a lawyer would see it any differently than what I did, but obviously we have concerns about bankruptcy.

Seeing that it might be exceedingly difficult to amend the Bankruptcy Code to deal with this, I want to proposed something and get anyone's reaction to this. If the law were to require that contracts in the CFTC-regulated markets included a subordination agreement that confirmed in writing that customer accounts were to be the first ones paid, would that have any undesired consequences, and would that help us solve the problem with a bankruptcy court that does not appreciate the fiduciary obligations?

Mr. DUFFY. I know Dan has got this in his testimony, but I will make one comment on that. I think that it makes sense, and it is hard to say that the consumer should not come first. But when you are looking at some of the smaller FCMs or if you just come out, the emergents that are in our world today that—you got to remember, banks will not clear your constituents, ma'am. They do not do that. They only clear the big participants. So the smaller brokerage firms need to clear the other participants. If, in fact, you made them subordinate to the clients, they may not be able to get funding to keep those smaller FCMs in business. That is just an unintended consequence. I am not saying it could happen, but that is one of the things, as a consumer, it is really hard for me to say that the customer should not be paid first.

Chairwoman STABENOW. Thank you. Thank you very much, Senator.

Senator Chambliss.

Senator CHAMBLISS. Thanks, Madam Chair.

Mr. Cooper, testimony submitted by Better Markets refers to academic evidence suggesting that the aggregate level of speculation in the market adversely influences the behavior of prices and that more speculation does not always mean more efficient prices. The Commodity Markets Oversight Coalition on the second panel today has submitted an attachment to their testimony referencing a number of articles that purport to show that speculation degrades market quality or that high-frequency trading causes harm to the market.

Now, we all know that every market needs both speculators and hedgers in order to function properly. I understand from your testimony that MFA supports a data-driven approach to position limits.

Now, have you reviewed the testimony of Better Markets and the Commodity Markets Oversight Coalition? Are you familiar with the academic research? And could you just in general shed some light on this issue, please?

Mr. COOPER. Thank you, Senator. What I would say is that there are a numerous academic and Government studies from the CFTC, GAO, OECD, plus international agencies all consistently commenting on the role of speculators in the market. Those studies—study after study—have concluded consistently that, first, they have not found excessive speculation to be the cause of market volatility in recent years; and, secondly, they show that policies restricting investors' access to derivatives markets would impair the ability of commercial participants in the markets to manage their risk. We are in favor of a data-driven approach, a very careful assessment of what the facts are with respect to position limits or other restrictions on the ability of traders generally to access the markets.

Senator CHAMBLISS. Mr. Duffy, with respect to high-frequency trading, some of the panel have raised concerns about the role of high-frequency traders in the marketplace. Some have suggested that this trading activity is responsible for market disruptions such as the mini-flash crashes in recent years or sudden price spikes. Can you give us your perspective on the role of high-frequency traders? And is this a term that has been actually defined by regulators?

Mr. DUFFY. Thank you, Senator. I think that high-frequency trading is getting a very clouded name at best right now. When it comes to mini-flash crashes or not, that basically does what market structure because of the fragmentation that we have in the securities world today where you do not have the vertical silos that pulls the liquidity in one central place.

I think what is critically important for the American public to understand about high-frequency traders, trading is going fast. Technology is going to continue to go fast, and you are not going to put technology back in a bottle. So it is up to exchanges like CME Group, groups like NFA and others, to come up with ways to show the public how we are policing these participants, and that is exactly what we do. We spend over $40 million a year policing our marketplace, a lot of that dedicated toward high-frequency trading.

We can say it all we want, that these are good liquidity providers, but we have to show the American public that we are making certain that nobody is front-running an order or anything else that they are being accused of doing.

Senator CHAMBLISS. Mr. Duffy, I had significant conversations with Chairman Gensler leading up to the ultimate draft and passage of Dodd-Frank relative to the way we are going to treat swaps and derivatives, which all of us knew some changes needed to be made, but I felt like that the direction we were heading in and where we wound up was pretty excessive, particularly with the regulations that we knew were going to be forthcoming from CFTC, and they have not even been completed yet. We still do not know what they all are. And the issue that I kept raising with Chairman Gensler was, What is this going to do to American markets versus European markets and Asian markets? And the standard answer I got was they will follow us.

Well, I see where the—and, interestingly enough, I was in Europe on a couple of occasions after those conversations, and I related that conversation to some of the folks in Europe, and they just got this wry smile on their face.

Can you give us the benefit of where we are with respect to competitive advantages or disadvantages as a result of Dodd-Frank today?

Mr. DUFFY. Well, I hear what Chairman Gensler is saying, that they will follow us, but I am still perplexed on seeing what laws that have been passed today in Europe or anything that has even been proposed or passed throughout Asia. There are things proposed in Europe but that have not yet passed. So we have already gone with the passage of Dodd-Frank. I just returned from a European trip, meeting with clients all throughout Europe, and when you make that reference to them, they are not just sitting around being beholden to the United States of America anymore. There are very sophisticated trading operations all throughout Europe, and they are garnering more and more market share each and every day, and this is something they feel quite excited about.

So I think they are looking at it as an opportunity. We are all big believers in regulation, Senator, but I think we need less regulation with more teeth into it. We cannot keep writing a bunch of rules that everybody can just circumvent. Let us have rules that have teeth in them, and I think that is what the American public would want, and I think it is hard for the European counterparts or Asian counterparts to refute that type of activity. But we are not doing that. We are writing rules on listed derivatives markets today or listed futures markets that Congress did not have anything to do with in Title VII. It was about over-the-counter swaps.

So hopefully we can get back to what we are supposed to be doing here, but I will tell you that folks, especially in Europe, are smiling quite nicely right now.

Chairwoman STABENOW. Thank you very much.

I will indicate to members that we have begun what will be two votes. I will continue for another 10 minutes. We will try to have another two members be able to ask questions. We will recess and then come back afterwards. So please come back at us.

Senator Donnelly? I want to just say we are so glad to have Senator Donnelly chairing our Subcommittee on Commodities, Markets, Trade, and Risk Management, and his Subcommittee will be engaged in these issues, and we will turn to him.

Senator DONNELLY. Thank you, Madam Chairwoman. Thank you all for being here.

I do not have an academic study in front of me, and I do not have a Government study in front of me. But I am going to tell you what has happened in my home State of Indiana in the last couple months.

Gasoline was $3.40 one week. A week and a half later, 2 weeks later, $4.25. Any demand increase? None. Any supply reduction? None.

I called to the refiners. I said, "Are you making any less gas right now?" Our two largest suppliers to the State. "Absolutely not," both of them. Some refineries were down. It is a regular thing that has happened. You know, they were changing blends, regular thing that happens. But from $3.40 to $4.25. So I talked to everybody I could. Three weeks later, $3.13. That has nothing to do with supply and demand. But I will tell you what it did do. There are people in my State who were not able to buy food that particular week or had to cut down significantly on their groceries because of it, because all of a sudden their gas bill has gone from $40 to $60, and that extra $20 was the pair of pants for their kids or the groceries for their family.

There is a widespread belief that the markets are broken, that supply and demand have nothing to do with the price anymore, and that the game is rigged.

I called in to refineries to find out, and when they say, you know, "We are producing at the same amount." Demand is down, and the price has gone from $3.40 to $4.25. And I go home every weekend. Here in D.C. it was $3.62 when it was $3.40 at home, and it was

$3.62 when it was $4.25 at home. And you look for answers, and you say this is a rigged game, is what people think.

Back in 2011—and nothing affects families more, it seems, in terms of this whole global world of finance that we see, this moving, that moving, that every week people are trying to make ends meet, have to fill up their tank. And it is what I hear almost more than anything.

In 2011, Goldman Sachs analysts said for every million barrels on spec, 8 to 10 cents price increase. And, Mr. Cooper, I would ask, do you agree with that assessment?

Mr. COOPER. I cannot comment on the Goldman Sachs report. What I would say, though, is if we cannot rely on academic studies, if we cannot rely on real-world examples, if we cannot embrace and acknowledge that a data-driven approach is the only way to really understand what the issues are here, then I am not sure what we are left with. We cannot have policies that would disincentivize participants from actively participating in the markets so as to provide the energy manufacturer and the farmer the ability to effectively manage their risks—so that there is liquidity.

Senator DONNELLY. Well, let me ask you this: Do you think if, instead of 421 million barrels on a speculative oil market today, there were 100 million barrels on a speculative oil market today, do you think that if it was 421 or 100 that the price would be the same for a barrel of oil?

Mr. COOPER. I cannot comment on that, Senator. I am sorry.

Senator DONNELLY. Mr. Kelleher, do you have an opinion on that?

Mr. KELLEHER. Well, we have provided the data on plenty of studies that have shown, as have CMOC, that there is excessive speculation, and speculation is causing a tremendous amount of volatility. And, by the way, a lot of it is coming from this new great innovation from Wall Street called "commodity index funds" that nobody wants to talk about that pour somewhere between $300 and $400 billion a month into the markets every month, in the futures market over and over and over again.

One of the things we also do not have, Senator, is data. The CFTC needs access to data because—and this is another place where the physical trading of these big banks comes into play. When you look at it, they are all reporting record profits. Look at the FICC number, the fixed income, currency, and commodities. They are making billions and billions and billions, which just happened to correspond with the volatility and the increase in price.

I am not an academic. I do not have a Ph.D. either. But, you know, you do not need a Ph.D. for some of these things.

Senator DONNELLY. And I am not criticizing academic or Government studies. I am just saying you get a pretty good study on I–94 on your way home from O'Hare Airport as well.

Mr. Duffy, my neighbor from Chicago, you indicated you wanted to say something?

Mr. DUFFY. Just a quick comment on that, and I think what is important to note is when you look at the markets, you cannot really say they are broke, because I also have a concern that you have. When you cite a $3.40 to $4.25, then back to $3.13 after you make a call in gasoline in a week's time, I will tell you that the futures markets have been between $90 and $110 a barrel for 3 years. It has not moved. So to say that the futures market or the markets are impacting the price of that, what you just talked about, that fluctuation, you have the wrong panel up here asking that question.

Senator DONNELLY. Well, no, I think I have the right panel here, and I will ask the next panel, and I will ask other panels, too.

Mr. DUFFY. But with all due respect, the markets are not broke. If there is something going on that is nefarious in the marketplace by refiners or somebody else, that is who is making the markets go up and down. Markets in general have not moved, though. We are sitting at high prices in commodities overall, but that is due to a whole host of reasons from other countries, exporting our food products and everything else. We import the energy products, obviously. We cannot export oil in the United States. It is against the law. But the point is the futures market I oil has been in a very narrow range for a long period of time.

Senator DONNELLY. Right. I try to keep an eye on that, too. Oh, I am sorry.

Chairwoman STABENOW. I apologize. I am going to take you back, given the time here.

Senator DONNELLY. Thank you.

Chairwoman STABENOW. Given the time here on the votes.

I want to turn to Senator Klobuchar.

Senator KLOBUCHAR. Thank you very much, Madam Chairwoman. And, Senator Donnelly, we had the same thing happen in Minnesota on the gas prices and same experience. I have long believed there are speculation issues. There also was a refinery-closing issue, and I have a bill that actually Senator Hoeven is on to require the refineries to tell the Department of Energy when they are going to close down so we can better stagger the closures. But I would agree with you on the speculation, so you should look at the bill.

Mr. Roth, you are sitting there by yourself and not many people have asked you questions, and you are on my end, so I am going to start with you.

I know you spoke a bit about some of these customer issues, and the failure of MF Global resulted in an unacceptable outcome for customers who had posted collateral with the firm, unacceptable because the Commodity Exchange Act specifically prohibits the use of customer funds for the firm's own needs.

The CFTC has now charged the company and its top executives with unlawful misuse of customer funds, and we must ensure that the improved protocols put in place will help better police the system. So we have a problem of dealing with the company, but we also have the problem going forward.

As we consider legislative changes relative to this matter, changes to customer funds segregation and potential reforms under the Bankruptcy Code, we need to make sure reforms are carried out to protect customers and also allow for a well-functioning futures markets.

Do you have any thoughts on this?

Mr. ROTH. Senator, I agree wholeheartedly with everything that you said, and that certainly, from a regulatory point of view, from the regulators' side, we have to constantly be—not just fight the last war, but try to anticipate the next war and try to always be trying to make the smartest use of technology and all of our resources to monitor member firms for seg compliance. That is why I think this daily confirmation process that we instituted with the CME is a huge step forward. I also think the rules that we passed regarding FCM transparency and financial data is a huge step so that customers do not have to root through Footnote 42 of an eight-page financial statement to find information about the FCM they are doing business with.

I also think the restrictions we put on firms' ability to draw out their own funds that are in the excess seg pool is a huge step forward.

But you are never done with this. It is a constant struggle. And until we figure out how to change human nature and eliminate fraud—and that is a ways off. I am working on that, but we just constantly have to try to strive to minimize the likelihood that anybody can ever get away with this, and if you can make it clear that there are criminal sanctions for this kind of wrongdoing, hopefully deter that conduct in the future.

Senator KLOBUCHAR. Very good. Thank you.

Mr. Kelleher, Dodd-Frank gave the CFTC the ability to establish position limits for swaps and futures held by "any one party." However, questions have been raised by regulators and others that "any one party" is difficult to define, especially as the CFTC moves forward with rewriting the position limits rule.

As they work to rewrite the rule, how can the CFTC help prevent market distortions so that no single entity has too large of a position in the market?

Mr. KELLEHER. Thank you, Senator. That is a good question because "any one person" also should include a class, as we have said both in the regulatory process and in our testimony here. Just because you are acting what appears to be a loan, but you are acting essentially identically to other market participants doing the same thing at the same time, for example, commodity index funds, among other actors working together, our view is that the CFTC has the authority to regular them and treat them as one under a class—the provision in the Dodd-Frank Act that allowed them treating a class as a trader. And it is very important to do that.

I would say it is pretty clear on position limits that the CFTC has done a lot of work. We did not agree with everything that they did, but I want to be—when the district court actually vacated the position limit rule, it did not, as has been stated in written testimony submitted to this Committee today, it did not overrule, second-guess, or question what the SEC did on the merits, period, the end. It was not a merits decision. It was as procedural decision on whether or not they interpreted a particular word that the court found was ambiguous. That is what is on appeal. So the position limit rule itself is not substantively questioned by the Federal courts. It is before the courts now, but on a procedural matter. And it is important that they get back to the business of regulating these markets. It used to be the case that these markets had about 70 percent actual commercial users, 30 percent speculators. It is now reversed. It is about 70 percent or more speculators.

Senator KLOBUCHAR. Right. I know.

Mr. KELLEHER. That has got to change.

Senator KLOBUCHAR. Very good.

Mr. Cooper, one last question. The CFTC is working with the Federal Reserve, the SEC, and its international counterparts to reach a final set of standards on margin requirements for uncleared swaps. You indicated that you have been advocating for an internationally uniform set of margin requirements in the uncleared derivatives market.

Why is it important that there is a balanced approach that harmonizes U.S.-based rules with the margin requirements at the international level?

Mr. COOPER. I think in the absence of a unified regime, it would make it incredibly difficult, costly, and burdensome for participants to manage their portfolios, manage their margin requirements, and transact freely across marketplaces.

Senator KLOBUCHAR. Okay. Very good. And I am not going to be back for the second panel, Madam Chair, but I wanted to say a special greeting to Honeywell who is going to be present, a company with a major presence in my State, and obviously you and I have discussed about the issue of the non-financial end users, something we care a lot about, and we look forward to submitting some questions on the record.

Thank you very much.

Chairwoman STABENOW. Thank you very much. We will recess. We do have at least one member who would like to ask questions of our first panel, so rather than dismiss you, I would ask for your patience for a few moments. We are at the end of the first vote. There will be a second vote, and I understand that at least one member would like to ask a question.

So at this point, we will recess and come back momentarily. Thank you.

[Recess.]

Chairwoman STABENOW. Senator Grassley has returned. I am going to ask, as I leave, with the full trust and confidence of Senator Grassley, I am going to leave him in charge of the Committee to ask his questions. I do believe that we have another member that may be returning, and I think what I will do at this point is, if they come back before I am back, we will let other members ask questions as well. Other than that, Senator Grassley, I would then just ask you to put us back into recess when you are done. Thank you.

Senator GRASSLEY. [Presiding.] Thank you very much for not taking your recess.

The Chairwoman started out with her first question—I have a follow-up for Mr. Duffy—in regard to fees, user fees. I guess this would be about a $315 million transaction tax. Would you have any estimate whatsoever of what that might break down to on a per transaction level?

Mr. DUFFY. So on a contract level, sir, we would have to charge per contract to get the $315 million. It would be roughly about 4.5 cents at a static volume in today's marketplace. So we charge on average roughly about 7.5 cents to our largest liquidity providers.

So we are looking close to anywhere between a 70-to 80-percent increase in every transaction they do.

Senator GRASSLEY. Okay. I appreciate that. I have a question for any of the panelists on high-frequency trading. It has developed and become increasingly sophisticated. I believe it is fair to say that there are some who appreciate it and some who do not. The question I have pertains to the margin requirements. I am sure there are multitude of strategies regarding high-frequency trading, but, in general, how would it be affected by some of the new margin proposals such as prefunding?

Mr. DUFFY. I can take a shot at that, Senator. Most high-frequency traders go home flat every night are not subject to the margin requirements because they do not have positions on an overnight basis. Very few have positions on—so I do not see how that would impact them to any great extent on that part of their business.

Mr. KELLEHER. I agree with that. They go home flat so it is not going to impact them. What I did want to say, Senator, is to congratulate you for being, if you will allow me to say, a bulldog on these issues. In your recent letter to the Survey Research Center to get to the bottom of what is going on and find out some basic information about preferential treatment, privileged access, and potentially unfair and abusive trading that relates to it. And it gets to an issue before us here in the reauthorization, which is that basically even now we still have remarkably dark markets where the CFTC and the public has very little information about what is happening, and HFT is a poster child for that. And this Committee, as has been talked about by the Committee in the past and you have focused on in the past, this Committee should authorize and mandate the CFTC to start requiring registration and getting data and information from the market players who are engaged in HFT, now to some reports 60, 70, 80 percent of the volume. And once the new derivatives market infrastructure gets in place, you can be sure that is what is going to happen. And we saw only a taste of that recently when the Wall Street Journal reported on high-speed traders exploit loopholes on May 1, 2013, and what they are doing or not doing at the CME.

Now, I do not know if what is in the article is accurate or not. I just know that it is a precursor to the future where HFT is going to move into this new market infrastructure in a big way and have the same disruptive aspects to it. And the CFTC needs the data and information from registration and authority now so that this Committee and that agency can get in front of the issues.

Senator GRASSLEY. Yes. That——

Mr. COOPER. Mr. Senator, could I just——

Senator GRASSLEY. Yes, please do.

Mr. COOPER. I do not think registration would accomplish anything. There are volumes of data available right now that can be used to assess the impact of high-frequency trading on the markets, and we think there is a positive impact, and it is not the impact you think. In fact, the U.K. Government-sponsored Foresight Commission as well as the SEC itself has conducted studies that show the beneficial impact. I think it is important to recognize registration of any individual category of trader is not going to enhance the information flow available to the regulators.

Senator GRASSLEY. Okay. If that is all you have to say on the subject, that takes care of my questions.

I would suggest, like she said, I should adjourn, but just in case somebody was going to come back here, if you would be polite enough, if somebody comes back, to let them take over, because I was fortunate enough, I was running back here, and she came back and reconvened for me. I appreciate that very much. Thank you all.

[Pause.]

Senator GRASSLEY. I guess there is more red tape to this than I thought. We are in recess.

[Recess.]

Chairwoman STABENOW. [Presiding.] The Committee will come to order. I apologize for the delay, but we are happy to be back. I know that Senator Thune has some questions.

Senator THUNE. Thank you, Madam Chair and Senator Cochran, for calling this important hearing, and I want to thank our panelists here for hanging around and giving us the opportunity to continue to ask questions.

Just as we talk about reauthorization of the CFTC, I think it is important to remember that we have got to do this in an intelligent way, make sure that as we increase customer protection and build confidence in the financial system, that is something that is going to encourage producers and firms to better manage their risk and provide the necessary liquidity that the market needs to function freely. But we also have to remember that we are operating in an international global economy, and the decisions that we make do not happen in a vacuum, and that any additional regulatory burden we place on firms here in the United States are going to impact the competitiveness of these firms in the global marketplace. So I hope we can strike a balance between managing risk, inspiring confidence, and allowing the market to function without overly burdensome regulations. And so I appreciate those of you who are here today giving us some insights about how best to do that.

I wanted to ask a question of Mr. Cooper. In the last Congress, I sponsored legislation which modified and updated securities regulations to help promote greater capital formation and improved transparency in the marketplace. I was pleased that the language was included in the bipartisan JOBS Act, which was signed into law by President Obama.

In your testimony, you have suggested that some of the provisions in the JOBS Act which directed the Securities and Exchange Commission to amend securities regulations governing private placements should be extended to cover commodity pool operators as well. And I am wondering if you can explain why this is needed and what the implications are if the CFTC does not amend its rules to be consistent with the JOBS Act or the SEC regulations.

Mr. COOPER. Thank you, Senator Thune. I want to thank you for your leadership as well on the JOBS Act, a tremendous piece of legislation designed to, in fact, and hopefully will, result in greater capital formation opportunities.

We have talked a lot about consistency and harmonization today in the cross-border context. This is a perfect example where we need consistency and harmonization that is between the CFTC and the SEC on this particular provision.

If the CFTC were not to amend its rules to make complementary changes to permit private placements essentially, it would thwart the very purposes in our industry that the provisions that were part of the JOBS Act were intended to promote, because, in fact, many of our members, the vast majority, are now dually registered. So not being able to participate in the broader general solicitation of private placements would, in fact, undermine the very purposes that the JOBS Act was intended to address.

Senator THUNE. Thank you. I want to take just a moment to take advantage that we have got a wide range of expertise and diversity of opinions on today's panel. Mr. Kelleher, you advocated user fee funding for expanded regulation by the CFTC on almost all fronts: high-frequency trading, physical commodity holdings, not to mention to help cover the costs of staffing and technology. Whereas, others have made the case that additional fees would increase the cost of hedging. An increase in the cost of hedging will then ultimately increase the costs of goods for consumers. And I am just kind of curious to know what your response is to that assertion or that criticism.

Mr. KELLEHER. Thank you, Senator. I would not say we are advocating fees across all boards for all—across all products, all markets, for all things. I think you have to find out that which fees are appropriate to be assessed on given the essential mandate and the funding needs of the CFTC. It is to the advantage of all the member participants in the markets, the investors, and the system that the CFTC have adequate funding on the technology side and the personnel side.

So when we look at it, we say, well, if you look at it, you have got—and I cannot remember what the numbers are exactly. I do not think Terry and I are going to agree on this. We are not talking about 1 percent. We are talking about probably fractions of a penny per contract. But, you know, if you took 25 CBO wheat contracts and you had half a cent per contract, you are talking about a 12-cent addition. If you took a larger size lot of 25,000 contracts, which would be a big trade, about $70 million worth of corn, you are talking about $125 on $70 million worth of contracts if it was half a cent. And if you actually look at the numbers and then you apply it to the numbers—now, everybody can disagree or have different views of what gets carved out for liquidity purposes and otherwise—you are talking about probably a very small fraction of a penny per contract. It would be so de minimis actually to end users and market participants that it is unlikely to have any effect at all. But where it has the most effect is we have a CFTC with a huge vital mandate that gets funded at a level that can service the market participants who have to register. You have SDRs, you look at the information flowing in that cannot be handled now. That is in the interest of everybody, including everybody at this table.

So I am not trying to get a huge fee. I am not trying to get more than a penny that is necessary. I think any fee should be as low as humanly possible and done in a targeted, sensible way so it does not impact liquidity and reduces the impact on all market participants, but generates enough revenue for the CFTC to get its vital job done, which everybody needs to have done.

Senator THUNE. Mr. Duffy?

Mr. DUFFY. Senator Thune, I think what is important when we are doing mathematics here, in order to get to the $315 million to fund the agency, you need to charge 5 cents per contract at the CME Group. That is a 100-percent increase on our liquidity providers. There is no question anybody that has a 100-percent increase in doing their business that they have to change the way they are going to do their business. And the way they are going to change it is they are going to do less activity and widen the spread, which will cause the consumers and the taxpayers and the Government more, especially when you are trying to auction off U.S. Government debt, and the only place they have to go to do the layoff is at the Chicago Board of Trade, which we own, and because our markets are so deep and liquid, the Government can auction off debt all day long to our participants, and they hedge it in the futures market. That bid-offer goes up, the cost to the taxpayer will go up right along with it. It will cost billions of dollars, sir. Billions.

Mr. KELLEHER. With all due respect, I think—and correct me if I am wrong, Terry, but you are only talking about the futures market. The jurisdiction of the CFTC will now include the swaps market. So if you take the total market, whatever the notional amount is, whatever you want to argue, you are looking at a market that is 6 times the size, or more, of the futures market.

Mr. DUFFY. But there are only 2,000 transactions a day, Senator Thune, that happen today in the over-the-counter opaque futures market—not in the futures, in the over-the-counter market. So even though it is 400 trillion notional, there are only 2,000 transactions a day. There are 20 million in the listed derivatives markets today.

Senator THUNE. Okay. Madam Chair, thank you. That was a good discussion. And I know you have a second panel you are waiting to get up here, so thank you very much for your indulgence, and I will yield back my time. Thanks.

Chairwoman STABENOW. Thank you very much. That was a good discussion. Thank you again for your patience in waiting. I appreciate all of your input, and we are looking forward to continuing to work with you. So thank you very much.

We will ask our second panel to come forward. You have been very patient as well, and we will proceed as soon as everyone is seated.

[Pause.]

Chairwoman STABENOW. Well, good afternoon. It is wonderful to have you with us, and we very much appreciate your perspectives and testimony this afternoon. Let me introduce our panel.

First on the panel is the Honorable Walter Lukken, president and CEO of the Futures Industry Association. Good to see you. Before moving to the private sector in 2009, Mr. Lukken served as Acting Chairman of the Commodity Futures Trading Commission for 18 months after having been a CFTC Commissioner since 2002. Also, he knows this Committee well, having worked under my former colleague, our former colleague, Senator Lugar. So it is good to have you back.

Second, we have Mr. Guilford. Mr. Gene Guilford is the national and regional policy counsel for the Connecticut Energy Marketers Association and is here today on behalf of the Commodity Markets Oversight Coalition. After working for a short time in the Reagan administration, Mr. Guilford returned to his home State of Maine to serve as president of the Maine Oil Dealers before moving to the Connecticut Petroleum Association. Welcome.

Mr. John Heck is senior vide president of The Scoular Company, and he joins us today from Omaha, Nebraska, on behalf of the National Grain and Feed Association. Mr. Heck sits on the Board of Directors of NGFA. Mr. Heck has been with The Scoular Company since 1981 when he first joined as a grain merchandiser, so it is great to have you with us as well.

Next we have Mr. Donald Russak, executive vice president and CFO for the New York Power Authority, and he is here today on behalf of the American Public Power Association. Mr. Russak has served in numerous positions with the New York Power Authority throughout his 33-year career, so we are glad to have you.

Finally, Mr. Colby. We have Mr. Jim Colby, who is the assistant treasurer at Honeywell International. He has also worked at Bear Stearns, UBS, and General Motors. Thank you for joining us this afternoon as well, Mr. Colby.

So we will now turn to you, Mr. Lukken, for your testimony.

STATEMENT OF THE HON. WALTER L. LUKKEN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FUTURE INDUSTRY ASSOCIATION, WASHINGTON, DC

Mr. LUKKEN. Well, thank you, Chairman Stabenow and Ranking Member Cochran. As you turn your attention to CFTC reauthorization, the Futures Industry Association stands ready to assist. FIA is the leading trade organization for the cleared derivatives markets.

As you know, clearing ensures that the financial integrity of the market is protected from the failure of one of its market participants. Futures commission merchants, or FCMs, play a critical role in facilitating the clearing process by guaranteeing the transactions of customers and serving as the front-line gatekeepers of market risk through the collection of customer margin.

FIA's mission since its inception has been to protect the public interest through the adherence to high standards of professional conduct and financial integrity. In carrying out this mission, FIA responded to the unacceptable consequences brought about by the failures of MF Global and Peregrine Financial Group. FIA formed a Customer Protection Task Force in the aftermath of these insolvencies and recommended a number of changes that have already been adopted, which include the enhancement of FCM recordkeeping, reporting, and early warning indicators, including: the filing of daily segregation balances with regulators, the creation of an automated daily verification system for customer segregated balances directly with banks and other depository institutions, and the collection and posting of additional FCM financial information onto an online system to help customers monitor and assess the health of their FCMs.

Much has been accomplished through these efforts over the last year and a half, and we continue to evaluate additional ideas such as the idea of customer protection insurance. The FIA, CME, NFA, and the Institute for Financial Markets have partnered to fund a study on the costs and benefits of this idea. We look forward to sharing these findings with the Committee in the coming weeks.

In addition to these measures already implemented, the CFTC has proposed a set of comprehensive regulations to further enhance customer protection, and we support much of what has been suggested, including the codification of many of FIA's recommendations. However, with regard to how and when customer margin is determined and collected, the proposal drastically reinterprets the longstanding application of the statute, even though this provision in the Commodity Exchange Act has not been changed since 1936.

It is estimated that this reinterpretation to a firm's excess margin or residual interest amount could add $100 billion in additional required contributions into customer funds accounts. This will result in either customers prefunding their margin or paying to use the capital of their FCM.

Many commodity customers have expressed strong concerns with this proposal, which will increase the cost of hedging, cause consolidation among small and mid-sized FCMs, and limit execution choices for customers. The FIA supports many of the customer protection measures that the CFTC has proposed. We simply believe this one in particular has not been justified.

I would be remiss if I did not mention the implementation of the clearing mandate of swaps in the Dodd-Frank Act. Congress looked to the reliability and stability of the futures clearing system when it determined to extend clearing to swaps. Unfortunately, the rules being written to facilitate the clearing of swaps are in some case reinventing an already proven clearing process for futures.

For example, the global futures markets have long benefited from regulators around the world working collaboratively to properly regulate the trading and clearing of futures while relying upon each other's comparable regulatory regimes to ensure effective oversight.

In contrast to this mutual recognition approach, the lead-up to last week's compromise on cross-border application of cleared swaps under the Dodd-Frank Act caused significant uncertainty and confusion among the global regulatory and financial communities. While this last-minute guidance provides some clarity, there remains significant complexity and open questions on how global firms will get into compliance.

We now face an all too familiar path of having to request CFTC no-action relief to provide our members with the legal certainty to trade in the global markets. This may have been avoided through a formal APA rulemaking process instead of mere guidance.

Even in the case where Congress granted specific recognition authority under the Dodd-Frank Act to exempt comparably regulated non-U.S. clearinghouses, there has been no guidance as to how this exemption, specifically allowed by statute, may be achieved. This compares to the futures markets that have functioned across borders without major incidents for many years under a recognition system.

In closing, our members stand ready and willing to facilitate the clearing of swaps, just as we have for futures. But it is important as we implement these important changes in the market structure for swaps that we not harm the futures markets that have served our industry well over time.

Thank you, and I welcome any questions you may have.

[The prepared statement of Mr. Lukken can be found on page 150 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Mr. Guilford.

STATEMENT OF GENE GUILFORD, NATIONAL AND REGIONAL POLICY COUNSEL, CONNECTICUT ENERGY MARKETERS ASSOCIATION, CROMWELL, CONNECTICUT, ON BEHALF OF THE COMMODITY MARKETS OVERSIGHT COALITION

Mr. GUILFORD. Thank you. Honorable Chairwoman Stabenow and Ranking Member Cochran and distinguished members of the Committee, on behalf of the Commodity Market Oversight Coalition—CMOC—we wish to thank you for the opportunity to appear before you here today on the matter of the reauthorization of the Commodity Futures Trading Commission and associated issues with regard to CFTC's authorities regulating the activities in the commodity markets.

Just very briefly, let me tell you that, since 2007, the Commodity Markets Oversight Coalition is a nonpartisan alliance of organizations that represent commodity-dependent American industries, businesses, end users, and consumers. We are the farmers, truckers, mom-and-pop gas station operators, airlines, and others who rely on transparent, functional, and stable commodity markets in which to hedge our operations for the mutual benefit of those who deliver tangible goods to markets and from whom we receive tangible goods from those markets, for the benefit of the millions of consumers that we serve. Our members rely on functional, transparent, and competitive commodity derivatives markets as a hedging and price discovery tool and as an essential part of our business operations. 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.

When accepting the John F. Kennedy Profiles in Courage Award in 2009, former CFTC Chair Brooksley Born stated, "Special interests in the financial services industry are beginning to advocate a return to 'business as usual' and to argue against the need for any serious reform. We have to muster the political will to overcome these special interests. If we fail now to take the remedial steps to close the regulatory gap, we will be haunted by our failure for years to come."

That was not the first time she issued a warning with regard to the necessity of appropriate transparency, accountability, and oversight of the derivatives markets.

Now, there are several issues that we would recommend to the Committee that the Committee undertake, and we would look forward to working with the Committee as we go forward with this reauthorization process.

The first on our list is manipulation and excessive speculation, and the Committee should examine the efficacy of the October 18, 2011, position limits rule as well as the underlying statutory authorities of the CFTC in preventing manipulation and the harmful effects of excessive speculation.

The previous panel questioned whether or not you had the right panel in order to address these questions. I would like to take a moment, if I could, to suggest to you, with all due respect, you have the right panel. In the last 2 weeks, the NYMEX RBOB contract has increased 43 cents a gallon. In the last 2 weeks, crude has increased $10 a barrel.

Let me put into context what 43 cents on the RBOB contract means: 43 cents is $155 million a day in higher gasoline costs on the American people; it will cost a billion dollars a week. And why would that be the case? Why would that be necessary?

We have circumstances that I would like to get into in question and answer hopefully about what happened before the financial crisis and where we are as of 2012. We have had enormous demand destruction in gasoline demand in the United States for the first time since World War II, a substantial decrease in demand for gasoline. For the first time since 1960, we are net exporter of gasoline. For the first time since Harry Truman was President, in 2011 we became a net exporter of distillate fuel.

We are importing less crude oil than at any time since President Clinton's first term. Last year, we had the greatest single increase in daily production of crude oil in the United States history since 1859. And yet through all of that, before the financial crisis and after, we have gone from 72 barrels on crude—$72 a barrel on crude to $94. And it was not a straight line. It is up and down constantly, daily, with enormous volatility. And we have added just another 10 this last week. On gasoline, we have gone from $2.80 to $3.68.

At a period of time when the American people have used less gasoline, not more, we have a surplus of gasoline that we can sell into world markets. With all due respect, the accountability and transparency and oversight of these markets is exactly the reason why the Commodity Futures Trading Commission needs the authorities that you have given it so that we can determine what is going on in these markets, what is motivating them and what is moving them.

We have a number of suggestions, and we would like to work with the Committee as we go forward in this process, especially with regard to resources. An agency that collects $2 billion in fines for the Federal Government may not necessarily need a tax, but it certainly needs more resources.

Thank you very much for your time.

[The prepared statement of Mr. Guilford can be found on page 89 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Mr. HECK.

STATEMENT OF JOHN M. HECK, SENIOR VICE PRESIDENT, THE SCOULAR COMPANY, OMAHA, NEBRASKA, ON BEHALF OF THE NATIONAL GRAIN AND FEED ASSOCIATION

Mr. HECK. Thank you, Chairwoman Stabenow, Ranking Member Cochran, and members of the Committee. I am John M. Heck, senior vice president of The Scoular Company in Omaha, Nebraska. Scoular manages commodity supply chain risk for customers in food, feed, and renewable fuel markets, and we assist farmers in tailoring their risk management solutions utilizing 61 grain-handling facilities across the country.

Today I am representing the National Grain and Feed Association. Today I would like to focus primarily on a rule proposed by the CFTC last November that would radically change the way business is done in the futures industry, and we believe strongly, despite CFTC's goal of enhancing customer protection, that two provisions of the rule would actually cause a dramatic increase in customer risk.

The first position would decrease the time in which customers' margin calls must arrive at their futures commission merchant, or FCM, from the current 3 days to just 1 day. Otherwise, the FCM would have to take a capital charge for that undermargined amount. Even in today's environment of money moving electronically, 1 day is not sufficient for all customers to maintain the current 3-day timeline. Otherwise, we fear some FCMs would require customers to pre-margin their hedge accounts, potentially putting more customer funds at risk in the event of another FCM insolvency.

The second provision of concern, maybe more troubling than the first, would change the timing of FCMs' calculation of residual interest. Those are the funds that the FCM contributes from its own money to "top up" customer accounts until margin calls are received. For decades, this provision of the CEA has been interpreted by the Commission as allowing some period of time for FCMs to do this. The CFTC proposal would change that consistent historical interpretation to require that every customer be fully margined on a 24/7 basis. Now, that may sound like a good idea, but in the real world it causes major problems, especially among the smaller and mid-sized FCMs that serve production agriculture and agribusiness. This would severely stress FCMs' liquidity, leading us to fear, again, that pre-margining would be required of customers. An unintended consequence would be consolidation in the FCM world as smaller firms cannot compete with larger firms who could afford to top up customer accounts.

If I could bring this down to a real-world example, think about a typical country elevator in Nebraska. This elevator handles 5 million bushels of grain per year. Before harvest, the elevator might have 40 percent of its annual grain volume purchased from farmer customers and then hedged through forward futures contracts. Assuming a typical crop mix of corn, wheat, and soybeans, for corn the elevator has to post $648,000 with its FCM to establish its upfront futures position; soybeans, another $594,000; wheat, another $129,000. That is a total of more than $1.3 million the country elevator has sent to the FCM just to establish its futures positions.

Now let us look at the additional financial requirements if the CFTC proposal was put into effect. We will assume that the elevator's FCM would require pre-margining by the customer to cover a 1-day limit up move, a reasonable precaution by the FCM. The country elevator would have to send 1 million more to the FCM for the possibility of a limit up move that may never come. If MF Global had required pre-margining of this fashion, the country elevator would have had almost twice as much of its capital exposed to misuse and loss, about $2.3 million instead of $1.2 million.

We continue to be mystified about why the meaning of the Commodity Exchange Act has changed after decades of consistent interpretation. We would prefer to work this out with the CFTC, but there may be a need for legislative action to clarify the interpretation the futures industry has relied on for so long.

One final item of regulatory concern is the CFTC rule concerning recordkeeping by companies that are members of a commodity exchange. In the form prescribed by CFTC, we are not aware of any technology that currently exists that will capture the information required by the Commission. We are working with the Commission on clarification of this problem.

In conclusion, I have detailed the NGFA's other reauthorization priorities in my written testimony. We believe that the U.S. Bankruptcy Code needs to be harmonized with the CEA and CFTC regulations to clarify and ensure that customers come first in FCM insolvencies. We also believe that the futures customers should have access to some form of insurance as securities customers do. As you have heard from many other comments today, we are also awaiting a study from the FIA before recommending any particular structure.

Thank you for the opportunity to testify, and I look forward to any questions.

[The prepared statement of Mr. Heck can be found on page 121 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Mr. Russak.

STATEMENT OF DONALD A. RUSSAK, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, NEW YORK POWER AUTHORITY, WHITE PLAINS, NEW YORK, ON BEHALF OF THE AMERICAN PUBLIC POWER ASSOCIATION

Mr. RUSSAK. Chairwoman Stabenow, Ranking Member Cochran, and members of the Committee, I am testifying today on behalf of the New York Power Authority—or as it is known, NYPA—the State of New York, as well as the American Public Power Association. Thank you for the opportunity to testify on an issue of great importance to public power utilities in considering the reauthorization of CFTC.

NYPA is the largest State-owned public power organization, serving business customers, governmental customers, municipal electric utilities, and rural cooperatives throughout New York State. The electric energy used to serve these customers is subject to the forces of the volatile markets, and yesterday was a perfect example of this volatility. With temperatures approaching 100 degrees in many parts of New York State, the spot market price for electricity ran up into the hundreds of dollars per megawatt hour, as much as $500 a megawatt hour in New York City alone, up from $60 the prior week. This exposes NYPA's financial position and its customers to price risk and uncertainty.

NYPA uses certain hedging transactions to reduce its market risk, to stabilize revenue, and most importantly, to provide rate stability to our customers. Because of the transparency and certainty that will be provided in the swap markets, we continue to support the Dodd-Frank Act and the full funding sought for the CFTC in the President's fiscal year 2014 budget.

However, CFTC regulations implementing swap dealer rules of the Dodd-Frank Act have damaged our ability to protect our customers and ourselves from this market volatility. Under these regulations, a counterparty can engage in just $25 million of swap dealing activities with public power utilities before having to be required to register as a swap dealer. For all but the smallest of transactions, the number might as well be zero.

The threshold amount is also unfair to public power entities. The de minimis threshold for swap dealing activities with investor-owned utilities, entities against whom we compete, is $8 billion, or 300 times the amount. As a result of the $25 million threshold, a number of non-financial entities have refused to enter into financial transactions with NYPA, which naturally leads to increased costs to us and to our customers. This is imperiling jobs across the State as well as increasing taxes.

The problem is not unique to the power authority but affects public power utilities throughout the country. APPA members commonly report that counterparties are refusing to enter into swap transactions with them, and the numbers have fallen off by half or more. In fact, Grant County Public Utility District in Washington State went from 28 counterparties down to 2. The October 2012 no-action letter raises the special entity de minimis threshold from $25 million to $800 million for certain power-related transactions. However, additional restrictions on these have meant that counterparties are still not participating in the market with us.

Even CFTC's Scott O'Malia, in a keynote address this May, noted the irony that the CFTC, in trying to protect public power utilities from the perils of the swaps markets, has instead forced us to trade only with Wall Street banks. He and other CFTC Commissioners have recommended further action, if not through regulation then through legislation.

On March 11, 2013, the Public Power Risk Management Act was introduced. This legislation provides very narrow and targeted relief for operations-related swaps for public power utilities. Specifically, the legislation would provide that the CFTC treat utility operations-related swaps with a utility special entity in the same manner such swaps are treated with other utilities, that is, made subject to the overall $8 billion threshold. This would put public power utilities on the same footing as investor-owned utilities.

The Public Power Risk Management Act was approved by the House Committee on Agriculture with a unanimous voice vote on March 20 and was approved in the House by a 423–0 vote on June 12. The legislation has since been sent to the Senate and referred to this Committee. It has been endorsed by the U.S. Chamber of

Commerce, the Consumer Federation of America, and the Commodity Markets Oversight Coalition. We would very much encourage this Committee to take up and approve H.R. 1038 or, as it considers CFTC reauthorization, to provide similar legislative relief.

Public power utilities are well versed in the markets in which we hedge price and operational risks. Forcing us to enter into transactions with only Wall Street firms provides no substantive benefit and, moreover, reduces the number of market participants with whom public power utilities can hedge their risk. Ultimately, this increases operational risk and hurts our customers.

Thank you again for the opportunity to testify, and I will be happy to answer any questions.

[The prepared statement of Mr. Russak can be found on page 161 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Mr. Colby.

STATEMENT OF JIM COLBY, ASSISTANT TREASURER, HONEYWELL INTERNATIONAL INC., MORRISTOWN, NEW JERSEY

Mr. COLBY. Chairwoman Stabenow, Ranking Member Cochran, and other members of the Committee, thank you for inviting me to testify. I am an assistant treasurer at Honeywell International, and today I speak on behalf of Honeywell, the Coalition for Derivatives End Users, and other commercial end users who are asking Congress to take quick action on S. 888 to provide non-financial end users hedging commercial risk with an exception from margin requirements in keeping with the original intent of the Dodd-Frank Act.

Honeywell is a diversified technology and manufacturing leader, serving customers worldwide with aerospace products and services; control technologies for buildings, homes, and industry; turbochargers; and performance materials. The company's more than 132,000 employees include 20,000 scientists and engineers who are focused on developing innovative products and solutions.

Honeywell is truly a global company, with more than 50 percent of our sales outside of the United States and therefore exposed to market risks from changes in interest rates, foreign exchange rates, and commodity prices. When appropriate, we hedge exposures through the use of derivative contracts to eliminate risks that we cannot control. We do not use derivatives for speculative purposes.

With a compliance deadline looming, end users ask the Senate to take quick action on S. 888 Without swift action on this legislation, which passed the House with an overwhelming bipartisan vote in June, non-financial end users will be forced to divert capital away from job-creating investments, sidelining billions of dollars in margin accounts. According to a Coalition for Derivatives End Users survey, a 3-percent initial margin requirement could reduce capital spending by as much as $5.1 to $6.7 billion among S&P 500 companies alone and cost 100,000 to 130,000 jobs.

To demonstrate how non-financial end users use derivatives to manage risk, I will provide an example of how Honeywell uses derivatives. We sell satellite and launch vehicle inertial measurement units manufactured in Florida to customers in Germany. Europe is a key growth market for commercial space products and, in order to qualify for consideration on certain opportunities, we may be required to enter into contracts denominated in euros even though all costs of production are incurred in U.S. dollars. The period for this type of contract can span multiple years, during which changes in the value of the euro versus the U.S. dollar can significantly impact the economics of the project. To mitigate this risk, we may enter into a forward contract to sell an amount of euros equal to our net exposure to lock in the market rate.

To shed some light on Honeywell's potential exposure to margin requirements, we had approximately $2 billion of hedging contracts outstanding at year-end that would be defined as a swap under Dodd-Frank. Applying 3-percent initial margin and 10-percent variation margin implies a potential margin requirement of $260 million. Cash deposited in a margin account cannot be more productively deployed in our businesses and as a result limits our ability to promote economic growth and protect American jobs.

In approving the Dodd-Frank Act, Congress made clear that end users were not supposed to be subject to margin requirements. Nonetheless, regulations proposed by the prudential banking regulators would require end users to post margin. This stems from what they view to be a legal obligation under Title VII, not because they view it as necessary for the safety and soundness of the financial system.

Dialogues between Senator Mike Crapo and Federal Reserve Chairman Ben Bernanke and between Senator Tester and Governor Daniel Tarullo during Senate testimony underscore why passage of the margin bill is necessary and why the Senate should have confidence in taking quick action. As Governor Tarullo made clear last week, passage of this bill would simply remove what they believe to be the requirement under Dodd-Frank to impose margin requirements while leaving intact the "ability to use [the] full panoply of supervisory tools." He further stated that the Fed does not need any additional authority to promote safety and soundness in the financial system and good risk management practices among regulated entities. Passage of S. 888 would not remove the ability of banks to set margin requirements on end users as part of their credit risk management process.

The legislation in no way begins to dismantle Dodd-Frank. It would simply ensure that the final act and rules function as Congress intended and that commercial end users do not face the same regulatory burden as those who speculate and create systemic risk.

In conclusion, we need the Senate to quickly enact S. 888 so that end users like Honeywell will continue to have the ability to manage risk without having mandatory and unnecessary margin requirements imposed. Mandatory requirements would divert cash from investment and job creation. Regulators have made clear that they are not necessary for the safety and soundness of our financial system.

Thank you for inviting me to testify today. I look forward to answering any questions that you might have.

[The prepared statement of Mr. Colby can be found on page 65 in the appendix.]

Chairwoman STABENOW. Well, thank you very much to each and every one of you. Mr. Colby, let me just indicate that, first of all, I was very involved in the effort on the language on end users in Dodd-Frank, and I think Congress has been very clear about the fact that we want to maintain the ability for market participant to use markets and to safely hedge, and so I share your concerns on this issue. This is something we have actively been involved in on this Committee and with the CFTC, and I realize the broader issues with the Fed and so on right now. But could you just take a moment to talk just a little bit more about what it would mean if you had to post margin as it relates to reducing your hedging activities?

Mr. COLBY. Well, what it would do is—I mentioned the $260 million figure. That is cash that we could be investing in the operations of the company, creating capital expenditures, creating jobs, and promoting economic growth. But instead, if we put it into a margin account, it is going to sit idle, and we cannot spend it. We cannot spend the same dollar twice. If it is sitting in a margin account, it means we cannot invest it in the business.

Chairwoman STABENOW. Thank you very much.

Mr. Heck, a priority for all of us is that the markets are safe and work well for commercial hedgers. Given all the changes in the last year as we look at rules, as we look at other changes with NFA that we heard about today, and CME and so on, those proposed by the CFTC, do your members feel safer using the futures and the swaps markets today?

Mr. HECK. Senator, I think they do feel—I do think they feel safer today. I applaud the NFA for the self-regulatory changes they have made. A lot of those mirror recommendations made by the NGFA's task force shortly after the MF Global bankruptcy.

I also think the CME has made significant progress in making our funds safer due to the changes they have made at the clearinghouse level.

We do believe that there are other avenues to explore. We are not seeking a legislation solution. I think we would be interested in and have told the CFTC we would like to work on a pilot program with them that would involve a fully segregate customer account, and that kind of account exists in parts of the swaps industry right now. We would like to do that. And as I said, we would also like to see the results of this insurance study to see if that is a feasible alternative for our members.

Chairwoman STABENOW. So from your perspective, your members would be willing to pay for full segregation at this point?

Mr. HECK. I think that depending on the size of one of our members, segregation, full segregation of the cost of that would be something they would be interested in. But, again, we would really like to see that be optional between the FCM and their customer.

Chairwoman STABENOW. Mr. Lukken, let us talk a little bit more about that from your perspective. If there were changes made to the bankruptcy laws that made full physical segregation feasible, would your member futures commission merchants offer that to customers? Is the Bankruptcy Code the only issue that is standing in the way? And do you see a demand at this point in the marketplace for full physical segregation?

Mr. LUKKEN. Well, we would support an optional full segregation approach. I think we are dealing with this issue in Europe currently where EMIR requires not only omnibus accounts but also optional individually segregated accounts. The question is cost, whether people are willing to pay the cost to have that extra set of protection.

If you are losing the fellow customer risk, that shared insurance level, it is going to cost because that risk is going somewhere, like squeezing a balloon. So somebody is going to have to pay for that risk, so that is the reason the costs are going to have to go up.

Chairwoman STABENOW. Thank you.

Mr. Guilford, I see Senator Donnelly here, so I am going to let him talk to you about gas prices. I know he wants to talk to you about gas prices, so I will let him have those questions, although I am also equally interested. But since you represent a company that would be, in effect, regulated by the CFTC, why are you supportive of increasing its funding and growing the agency? Why is that important for your members?

Mr. GUILFORD. If I might, I would like to take you back to 2008——

Chairwoman STABENOW. We need you to push the button.

Mr. GUILFORD. Thank you. I will take you back to 2008, but I will make it really brief and not as long as 2008.

Chairwoman STABENOW. Good.

Mr. GUILFORD. In 2008, we had crude oil at about $70 a barrel in March. I testified before House Energy and Commerce about a month before it reached its peak in July of that year of $147, and by November it had fallen back to $32.

Now, during that span of time, we had major Wall Street investment banks claiming that crude was going to go to $200 a barrel that year. That resulted in the customers of our heating oil retailers rushing to their heating oil retailer saying, "Lock us in, protect us from this Armageddon that is coming." So a lot of these consumers, hundreds of thousands of these consumers, with thousands of heating oil retailers, went into these markets and locked in prices of between $4.50 and $5 a gallon for their winter heating fuel supply.

Unfortunately, by the time we got to November and that market price fell to $32 a barrel, we had market price heating oil, physical heating oil, at $2 a gallon. Well, imagine that you are a consumer and you laid out $4.50 a gallon for 900 gallons of heating oil for your winter supply, and the actual market price at the time had fallen to $2.

So we had a lot of angry consumers, and we had a lot of very unfortunate heating oil retailers because they are decent business people and they have done business for three and four generations, wanted to make sure they took good care of their customers, who let a lot of those customers out of those contracts in order to be able to keep them as customers, but not without a tremendous cost.

It was clear to us then that these markets are dysfunctional. They do not operate for the purpose in which they were intended. And what we heard all through that period of time—and appreciate, if you will, Madam Chairwoman, that we were told at the time that this was all because of supply and demand. Now, the previous panel discussed that you do not need to be a Ph.D. to understand some statistics. Tell me, if you would, please, because it has not been answered for us in 5 years, why we had a situation where there was a supply and demand dynamic that drove it from $70 to $147 in 4 months. Where was the extraordinary interruption in crude oil supply or the extraordinary increase in demand within 4 months that more than doubled the price of crude? And then, right after the 4th of July, after we celebrated Independence Day, it begins to fall in another 4 months from $147 to $32.

So whatever circumstances attributable to supply and demand that occurred in the first 4 months apparently evaporated and turned 180 degrees in the second 4 months.

Madam Chairwoman, in answer to your question, we need to have absolutely transparent, accountable, and adequately overseen financial markets, because we rely on these markets to be able to do one very simple thing for our customers. Our customers come to us and ask us to be protected—protected from the vicissitudes of the economy and the marketplace, and that is what we like to be able to do. And we like to be able to do it in a way that protects them, protects us. We can earn a decent living and manage to take care of consumers. We could not do that in 2008.

Chairwoman STABENOW. Okay. Thank you very much.

I am going to turn now to Senator Cochran.

Senator COCHRAN. Following up on the last comments, what would we do if we wanted to introduce legislation and identify changes in current law that would lead to the result you just wished for?

Mr. GUILFORD. Well, it is important, I think, Senator, to take this on several different levels. First of all, we started working on something as simple as closing the Enron loophole. You will recall that. We worked on that with you and others in the Senate back in 2008. Now, there was a clear example of an instance in which a lack of transparency in the markets resulted in the citizens of California going from paying $7 billion for electricity to $27 billion for electricity. There is no doubt about the fact that there was manipulation. Nineteen people went to jail. A 20th would have had Mr. Lay not passed away. An enormous amount of manipulation in one market by one company. And what we attempted to do at the time was to close the loophole by taking over-the-counter and electronic trading out of the dark markets, to shine a light on it, to make it transparent, to require things to go through mandatory clearing—all of the things that we eventually managed to be able to do to a greater extent in Title VII but did not entirely succeed in perfectly, certainly. But we certainly did not do it when we passed the farm bill in 2008.

Well, transparency in these markets, knowing what is going on, to be able to see all of the market participants and knowing what they are doing is critical.

We would take you in a couple of other directions. One of the things we would like to see the authority of the CFTC to have is not necessarily to be able to in the first instance regulate index funds, but to be able to have the authority to be able to look and make sure they understand what they are doing. Understand that the concern that we have, and to follow up on the comments of Mr.

Kelleher on the previous panel, is to address the issue of how there is such an imbalance today of 70 percent financial market participation in these energy commodity markets and 30 percent actual market participants, people and airlines and farmers and truckers who want to hedge their products.

We would like to be able to make sure that these markets are functioning for the purpose in which they were intended, and I think that we have forgotten why that was the case.

For over 100 years, we had enormous stability in this country in energy prices, and it was not until the 1970s that they became unstable. That is when we created the CFTC, gave it its original set of authorities. We wanted to create a world marketplace in order to be able to wrest control of energy markets away from OPEC. And for about 25 years, it worked brilliantly, absolutely brilliantly, but in the last decade not as well. And I think that a lot of that was attributed to the fact that, unfortunately, a mistake was made both in 1999 and in 2000 in deregulating these markets and closing them off so that we did not see what they were doing.

So in the first instance, let us make sure we understand exactly what is going on in these markets. Let us make sure we have an agency that is paying attention to what is going on in these markets, because when what we have seen going on in the last week, Senator, 43 cents on gasoline in 2 weeks, $1 billion a week it will cost the American people in higher gasoline costs, we better have a really good answer to be able to give people about why that is occurring. And we do not have a very good answer today, and it starts at the CFTC at least with what is going on in the commodity markets because that is where the activity is occurring that is driving these prices.

Senator COCHRAN. And we are out of gas. That is the other part.

In terms of production, what is the level of production compared with the way it was 5 years ago, 10 years ago? Is it going down or is it going——

Mr. GUILFORD. Great question. Thank you very much. Before the financial crisis, America was consuming about 20 million barrels a day of crude oil, before the financial crisis in 2007. In 2012, it was 18.5 million barrels. We had a million and a half barrel a day decrease in crude oil consumption, an enormous—cataclysmic in the energy business that we would have that much demand destruction. At the very same time, during the same period, America has produced an additional 1.5 million barrels a day in domestic production, another cataclysmic event. The biggest single increase in daily production of crude oil in the history of the United States since 1859 when we began commercially producing crude oil. Extraordinary.

Combine those two issues, it is a 3 million barrel a day swing in just crude. And yet what happened between those two dates? We went from $72 on crude to $94. And, again, not a straight line. So a 3 million barrel a day swing in crude in the world's largest economy and largest consumer of petroleum products, and yet we had a $22 a barrel increase in crude and another $10 last week. Another $10.

Now, on gasoline, gasoline during the same period of time, we went from, in 2007, 9.3 million barrels a day consumption of gasoline to 8.7 in 2012. The first time since World War II that Americans consumed that much less gasoline, almost 600,000 barrels a day.

Now, for the economy, just as a statement of fact, in 2007 we had a 4.6-percent unemployment rate; in 2012, it was 7.6. And yet we hear out of Wall Street most recently, with the June jobs report, that we needed to tack on another $3 or $4 barrel on crude because we had a robust jobs report. The robust jobs report was up 360,000 on part-time, down 240,000 on full-time, and U–6 went from 13.8 to 14.3. I do not think you need to be a Republican or a Democrat to understand that does not meet the test of robust. And yet out of Wall Street, we needed to have an increase in the price of a barrel of crude.

I do not find that justified. I do not.

So we have had enormous changes in the energy markets in this country in the majority for a tremendously good reason, but I do not necessarily think those have always been reflected in the prices that Americans pay.

Senator COCHRAN. Well, that is one of the reasons why we are having these hearings.

Chairwoman STABENOW. It is.

Senator COCHRAN. It's to get some answers and find out what the heck is going on. And if there is responsibility here in Washington, in the United States Senate specifically, we want to hear some suggestions about what we should consider.

Thank you very much for being here and helping us in this effort.

Chairwoman STABENOW. Thank you very much.

Senator Donnelly.

Senator DONNELLY. Thank you, Madam Chairman. I would just like to note to Mr. Lukken, a graduate of Indiana University, we are very proud of you, and I know you worked on the Agriculture Committee under Senator Lugar, who was my predecessor, and it is filling awful big shoes following him, and I want to appreciate all your service that you gave not only to him but to the country. Thank you very much.

To Mr. Russak, I will sponsor the Public Power Risk Management Act. I have talked to Indiana's municipal power agencies, and they are looking for help on this. And we have seen that the CFTC recently released a no-action letter temporarily raising the special entity threshold for utility-related swaps. Has that helped? And obviously we need a permanent solution to this. We are working hard on this. Has the temporary helped at all?

Mr. RUSSAK. Well, Senator, unfortunately, not very much because of the temporal nature of this. The counterparties, the non-financial counterparties, have not been willing to step up to the plate and offer up their services to us. So it really did not help the public power entities. We have the same issues in New York State as well with the New York municipal electric utilities, and the Power Authority itself having seen 20 percent of its counterparties going away.

Senator DONNELLY. Well, I want you to know we will work as fast as we can to get a companion bill on this side and get that put in place. We want to get some certainty for the municipal power agencies all over the country.

Mr. RUSSAK. Very much appreciate that, Senator.

Senator DONNELLY. Mr. Guilford, let me ask you, do you think that not having position limits in place for non-end users increases the per barrel price?

Mr. GUILFORD. Yes.

Senator DONNELLY. And, you know, as I indicated earlier, Goldman Sachs analysts around 2011 estimated around 8 to 10 cents per million barrels—or per barrel. What you are looking at with 421 million barrels—what is your estimate of approximately what you think it affects per barrel cost? Any ball park.

Mr. GUILFORD. I would like to put this in the context of what we said when we testified in the other body at Energy and Commerce and following the president of the world's largest energy company where he indicated that he thought it should be between $60 and $70 a barrel. I mean, in a classic economic sense, the cost of a barrel, it is the marginal cost of production of the next barrel, and that was his opinion. That was his opinion at that time. That remains my opinion today. And if I would, I think putting it in the context of what the position limits rule meant, if I could just for a moment?

Senator DONNELLY. Yes.

Mr. GUILFORD. I would like to make sure that I quote it accurately. Spot month was 25 percent of estimated deliverable supply for one trader, 25 percent of estimate deliverable supply. I do not know about you, Senator, but that does not strike me as a huge burden, 25 percent of estimated deliverable supply. The not spot month, 10 percent of the first 25,000 contracts, 2.5 percent thereafter.

Senator DONNELLY. Well, I would like to see——

Mr. GUILFORD. Not much of a limit.

Senator DONNELLY. Right. I would like to see a market that for end users, as you indicated, airlines, transportation, shipping, ag, if they are using a product, we want them to be able to lock in prices that they can live with, to have some certainty, to avoid risk. But it does not seem to me that the purpose of this market has been to speculate on the future of oil, the future of what happens to our families and going from $3 to $4 to $3 to $4.25, that it causes extraordinary hardship not only for families but for your companies that you represent as well to try to have some certainty in a market where supply continues to go up, demand continues to be steady or fall down, and the price of crude through position limits I think has really been affected.

Mr. GUILFORD. Absolutely, and just to follow up on that, if I might——

Senator DONNELLY. Or lack of position limits, I should say, has been affected.

Mr. GUILFORD. When we were there late last winter or early last spring, those of us who live in the Northeast remembered that we had the warmest winter on record in the history of recordkeeping. Outdoor sporting events were occurring all year round. I know they do in your State all year round, Senator Cochran. I assure you they do not in Connecticut. We usually close up sometime around Thanksgiving until, you know, just before Memorial Day. But golf courses were open all winter long. Our members lost 35 or 40 percent of their sales volume because it was so warm. The price of heating oil went up. The market price of heating oil went up. It did not go down. It should have collapsed, but it did not.

So, again, that is why we feel as though we need to make sure we have a CFTC that is adequately funded, adequately staffed, has the technology in place with which it can do its job, and to be able to tell us what is going on, because a lot of it does not seem to make a great deal of sense.

Senator DONNELLY. Well, I would like to thank the panel and, again, Mr. Lukken, we are proud to have you as a graduate of the Hurryin' Hoosiers.

Chairwoman STABENOW. Thank you very much.

Senator Roberts.

Senator ROBERTS. If we had only had the CFTC when Jimmy Carter put that embargo on the Russian sales. I remember at the Dodge City co-op—I cannot remember what the price was. I am guessing it was around $2.90, something like that, maybe 3 bucks. It went to hell in a hand basket, driven, of course, by speculators. That was the President of the United States. I am not sure the CFTC could have done that job, and I am just being sort of pesky with you.

Mr. Heck, we have heard from quite a few panelists or some of the panelists that the role of the commodity prices or markets have changed due to speculation, i.e., the speculators. For your members, are they looking at the speculator driving price swings, or are they looking to reduce their risks from these swings?

Mr. HECK. Senator, I think our members generally as the panelists commented before see a role for the speculators in our markets to bring liquidity, particularly in deferred periods where I have bought grain from a farmer for delivery in March of 2014, and I need to hedge that. If a speculator is out there wanting to take the other side of that trade, that is a good thing for us. So I think there is a role for that kind of liquidity in our markets.

I think that between our industry and the CFTC and the exchanges we have worked pretty well together to establish the right kind of position limits in our industry. I think they function pretty well. Occasionally we have had some issues with, you know, perhaps long index funds being in our market and causing a divergence between the futures price and the cash price. Again, through collaboration, we have made some changes to that contract that have made that a non-issue.

So I would say today in our industry our members are trying to work with each other and with farmers to minimize the risk inherent in price swings through prudent risk management tactics.

Senator ROBERTS. In your comments—well, I would just add that I know that we all want stability, we all want transparency to the degree that is possible. But I am not sure the CFTC issuing regulations allegedly to achieve that—not allegedly. They are actually trying to achieve it. But they are issuing interpretive guidelines. That is like sub-regulatory guidance. That is like a lot of things that are happening in Washington in a lot of different agencies and a lot of regulations. Three hundred pages' worth, I am not sure that is going to—we need transparency on the 300 pages.

In your comments you mentioned that the National Grain and Feed folks are concerned that the proposal for customer protection could end up significantly increasing the futures customers' risk in the event of future failures. In the real world, i.e., the countryside of Kansas, and Vermont, what are the challenges—and everywhere else, Mississippi, Michigan. In the real world, what are the challenges for shortening the amount that customers can make margin calls to 1 day instead of 3?

Mr. HECK. I do not think that from an industry perspective we have been able to determine why the 1-day rule would benefit anybody, frankly. And I think we need to continue to work with the CFTC to understand that. They have perhaps intimated that their hands are tied by the regulation, but the interpretation they have made is contrary to what has happened over decades.

Senator ROBERTS. Okay. Real quick, and my time is expiring. If the proposed rule on residual interest goes forward unchanged, will it dramatically impact farmers and ranchers using the market to hedge their costs?

Mr. HECK. Yes.

Senator ROBERTS. Thank you.

Mr. Lukken, thank you to the Futures Industry Association and other groups for being very proactive and paying with your own dollars, not the taxpayer dollars, to evaluate the costs and benefits of the many proposals to provide additional insurance for customer accounts in case of another futures failure. There is not a question. I just wanted to thank you.

It looks like I am out of time, and my wife tells me that I am already 20 minutes late, so, Madam Chairwoman, distinguished Ranking Member, the Hoosier from Indiana, Mr. Lukken, thank you for your service up here, adios.

Chairwoman STABENOW. Thank you. Thank you, Senator.

Thank you again. This has been a very important panel, very helpful, and your written testimony as well. We look forward to working with all of you.

Let me just indicate that any additional questions for the record should be submitted to the Committee clerk 5 business days from today. That is 5:00 p.m. on Wednesday, July 24th. Without objection, the compilation of letters received by the Committee with respect to reauthorization will be added to the record of the hearing.

[The following information can be found on pages 172-435:]

Chairwoman STABENOW. Seeing nothing further, the meeting is adjourned. Thank you very much.

[Whereupon, at 5:40 p.m., the Committee was adjourned.]

A P P E N D I X

JULY 17, 2013

Opening Statement
Senator Saxby Chambliss
Senate Committee on Agriculture, Nutrition & Forestry

Reauthorization of the Commodity Futures Trading Commission
July 17, 2013

Madame Chairwoman and Senator Cochran, thank you for calling today's hearing to discuss the reauthorization of the Commodities Futures Trading Commission and the Commodities Exchange Act.

This is a timely opportunity to confront a litany of issues surrounding our futures markets, our financial markets, and the operations of the CFTC. The futures market has gone through a unique evolution in the last 10 years, including exponential growth in derivatives use.

These evolutions are nothing new, but it is our job as Congress to ensure our legislative approach allows the least amount of intervention into private business transactions, while having as much participant and customer protections needed - a careful balance Congress already attempted through Dodd-Frank. Dodd-Frank's ambitious goals of bringing regulation to an unregulated industry and preventing future financial meltdowns were in many cases overly burdensome and ambiguous. In some instances the implementation of this legislation through rulemaking has proven to be poorly executed.

The effects of this overreach are being felt by more than Wall Street trading firms and big business. Risk management affects main street businesses as well. Whether they are pension managers, farmers, energy cooperatives, or large financial firms that often serve as intermediaries to these transactions, our global economy requires these individuals and firms to effectively manage their risk and conduct business without disruption. Good policy, effective oversight, and a balanced regulatory regime can only be put in to practice through clear and routine stakeholder engagement.

We have a host of witnesses today representing a wide view of the futures industry. Their views are important to keep in mind as the committee determines what areas this reauthorization should focus on. I was pleased to see the chair and ranking member go to great lengths to ensure industry stakeholders and market participants were given the opportunity to comment early on in the process. The witnesses before us today have already given us much to consider and will have the opportunity to elaborate on the statements they provided to the committee earlier this year.

One of the commonalities among many of the witnesses is a focus on customer protections - an issue at the heart of our responsibility as members of Congress representing our market participant constituents. Members of Congress, the CFTC, and the industry have all brought forth proposals for how we can improve the situation. The Futures Industry Association, who will testify in the second panel, has taken the initiative to study the idea of insurance for the industry – an idea that has been considered for some time. We all look forward to the results of their efforts to study this issue.

An issue I focused on during the Dodd-Frank debate, and has proven to still be problematic, is how we prevent overly-burdensome requirements for our end-users. Congress has given specificity to the regulators to exempt end-users from clearing and margin requirements; however, broad definitions and overly narrow interpretations by the CFTC mean many end-users are not exempt, driving up costs on customers and consumers. Through this authorization, the committee will have an opportunity to fix this and a host of other issues the witnesses will bring to our attention today.

I thank the witnesses for their input today and look forward to hearing their views on the issues I mentioned.

STATEMENT FOR THE RECORD
Senator Thad Cochran
Senate Agriculture Committee Hearing on CFTC Reauthorization
July 17, 2013

Madam Chairwoman, thank you for holding this hearing today. Reauthorization of the Commodity Futures Trading Commission (CFTC) is an important matter before this Committee. The issues being discussed today have far-reaching effects across the country and around the world.

I look forward to learning more about the Commission's actions as well as the challenges faced by the marketplace. I appreciate the contributions of approximately forty stakeholders and advocates who expressed their insight into this process through the submission of comment letters to this Committee.

In their written testimony, many of the witnesses have identified needed improvements to address shortcomings revealed after the failures of MF Global and Peregrine Financial Group. These are important issues that need to be discussed. The CFTC has been able to propose and implement many comprehensive customer protection enhancements without making legislative changes, most of which appear to be positively received. However, the customers whom these measures are designed to protect have recently expressed concerns with some of the CFTC's proposed changes, such as those dealing with the timing of margin calculations and collections. Given the overwhelming concern expressed by American farmers and ranchers, we must commit to thoroughly consider the costs that will be imposed on the actual customers before drawing any conclusions on proposed modifications to the Commodity Exchange Act.

It is important for the Committee to properly assess the full impact and costs associated with further changes. Often, American farmers and ranchers depend on small brokerage firms. Overly-burdensome and unnecessary margin rules or compliance costs could hamper the ability of these firms to operate, or these costs could be passed on to farmers, ranchers, and ultimately the American consumer. Neither of these outcomes would benefit the marketplace.

Unlike other elements of the Dodd-Frank Act, Title VII doesn't just impact large Wall Street banks. It imposes new regulations on "end-users"—including, manufacturers and government-owned utilities—that will ultimately impact multiple industries across various sectors of the U.S. economy. End-users make up ninety-four percent of the job creators in the United States and less than ten percent of the swaps market. While our country is still facing high unemployment, we cannot afford dozens of new over-burdensome regulations that impose costs on our job creators.

Today, as we embark on CFTC reauthorization, and study these issues, it is important to note that we are not starting from scratch. Our colleagues in the House have recently passed legislation that would address the concerns of commercial end-users, producers, utility companies, and others with overwhelming bipartisan support – several bills with more than 400 votes.

Taken together, consideration of these issues provides a great place for this Committee to start its dialogue. I also look forward to hearing from the witnesses today and learning more about the issues of concern that we should address.

Statement for the Record

by

The Honorable Kenneth E. Bentsen, Jr.

on behalf of the Securities Industry and Financial Markets Association

before the Senate Agriculture Committee

United States Senate

Re: Reauthorization of the Commodity Futures Trading Commission

Wednesday, July 17, 2013

Committee Chairwoman Stabenow and Ranking Member Cochran. My name is Ken Bentsen and I am President of the Securities Industry and Financial Markets Association (SIFMA).[1] SIFMA appreciates the opportunity to provide input on the reauthorization of the Commodity Futures Trading Commission (the "CFTC"). As the Committee considers the Commodity Exchange Act ("CEA"), we encourage consideration of the following issues, as discussed below.

Title VII of the Dodd-Frank Act ("Dodd-Frank" or the "Act") created a new regulatory regime for derivative products commonly referred to as swaps. Title VII seeks: to reduce systemic risk by mandating central clearing for standardized swaps through clearinghouses, capital requirements, and the collection of margin for uncleared swaps; to protect customers through enhanced collateral safeguards and external business conduct requirements; and to promote transparency through reporting requirements, new business conduct rules, and required trading of swaps on exchanges or swap execution facilities ("SEFs"). To date, there have been significant reforms put in place that market participants have and are working to implement. Late last year, firms engaged in significant swap dealing activities were required to register with the CFTC as swap dealers ("SD") or major swap participants ("MSP") and became subject to reporting, recordkeeping and other requirements, many more of which will be phased in over

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

time. Recently, the first wave of mandatory central clearing of swap transactions took effect, and soon certain cleared swap transactions will also be required to be traded on exchanges or SEFs. The establishment of global standards for margin requirements for uncleared swaps is near completion, with the final BCBS-IOSCO consultation on margin requirements for uncleared swaps expected this fall; soon after we can expect U.S. regulators to re-propose margin rulemaking for implementation in the U.S.

SIFMA supports many of the goals of Dodd-Frank's Title VII with respect to swaps. However, we remain concerned about how regulators, especially the CFTC, are interpreting and implementing many of these provisions. Indeed, in a few instances we also believe it is necessary that Congress amend the Act, as some provisions are duplicative and, at times, counterproductive. Poor implementation of Title VII has the potential to detrimentally limit the availability and increase the cost of derivatives, which are a valuable risk management tool for American businesses, including manufacturers and the agricultural industry.

We recognize the tremendous undertaking required by regulators in their efforts to implement derivatives reform. The volume and scope of the new rulemaking is unprecedented, with substantial implementation requirements for both the sell and buy side, and the end user community. Throughout this process, SIFMA has continually sought to engage with regulators in a constructive way as provided for under the Administrative Procedures Act.

As an overarching matter, it is our belief that the implementation of these new rules must be coordinated between the various regulators responsible for derivatives reform, both at home and abroad. This is critical to the successful implementation of Title VII and other similar regulatory frameworks, as our member firms are making dramatic changes to their business, operational, legal, and compliance systems in order to adapt to the new OTC derivatives regulatory regime. The implementation of these new rules is not as simple as flipping a switch. They require significant and multiple systems builds, testing, training, and new documentation involving both dealers and customers. Conflicting or redundant rules, at best, add unnecessary cost and, at worst, increase risk.

In the remainder of my testimony, I will focus on a few specific issues that are under the jurisdiction of the CFTC, which could have a profound impact on the success of Title VII and its effects on the marketplace. We urge you to consider them as part of the CFTC and CEA reauthorization.

Cross-Border Application of Title VII:

Section 722 of the Dodd-Frank Act limits the CFTC's jurisdiction over swap transactions outside of the United States to those that "have a direct and significant connection with activities in, or effect on, commerce of the U.S." or are meant to evade Dodd-Frank. Section 772 similarly limits the SEC's jurisdiction over security-based swap transactions to those conducted without the jurisdiction of the U.S., with like anti-evasion provisions. In seeking to clarify its jurisdiction, on July 12, 2013, the CFTC voted to approve final cross-border guidance, as well as a phase-in exemptive order, by a vote of 3-1.

As of this writing, while the phase-in exemptive order has been released and made effective, the CFTC has yet to release the final guidance, despite frequent cross-references between the two documents. Additionally, the CFTC has recently revised the phase-in exemptive order following its initial release. Given the short time frame between these actions and this hearing, as well as the delay between the releases and additional revisions, we have not had sufficient time to fully review and assess their impact, nor develop a clear understanding of their interplay.

Nonetheless, I would like to reiterate a few key points which SIFMA has stressed with regard to the cross-border application of derivatives regulation. First and foremost is the need for coordination and consistency, both between the CFTC and the SEC in the U.S., and among the global regulators working on implementing laws and regulations to meet the G20 commitments on OTC derivatives regulation.

Additionally, while encouraged by the joint actions of the CFTC and EU as discussed below, SIFMA continues to emphasize the importance of consistency and coordination between international regulators in implementing OTC derivatives reform in furtherance of G20 commitments. We believe that the international nature of the swap markets makes such global coordination, in addition to domestic coordination, critical in order to achieve an appropriate level of oversight of swaps activities. As you are aware, on July 8 SIFMA and 12 other trade associations sent a letter to the Chairs and Ranking Members of this Committee and the Senate Banking Committee sharing this concern, further noting that a premature finalization of cross-border guidance could cause market disruption and confusion, and additionally could hinder on-going efforts to allow for such consistent and coordinated regulation with the SEC and foreign regulatory authorities.[2]

In the days leading up to July 12, we saw some progress made in this area. On July 11, 2013, CFTC Chairman Gary Gensler and European Commissioner Michel Barnier issued a statement entitled, "Cross-Border Regulation of Swaps/Derivatives Discussions between the CFTC and the European Union - A Path Forward".[3] The announcement discussed a "joint

[2] http://www.sifma.org/issues/item.aspx?id=8589944333

[3] http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/jointdiscussionscftc_europeanu.pdf

understanding" on how cross-border approaches to derivatives regulation will work between the CFTC and EU, including instances in which the CFTC would allow for compliance with EU rules for certain requirements. The CFTC later issued four no-action letters to address aspects of this general agreement.[4] The "Path Forward" document references the need for both the CFTC and EU to take a series of actions to accomplish the coordinated approach described therein; however, there are still little details on how the laudable goal of implementing coordinated and consistent regimes is to be reached. Notwithstanding these developments, as the CFTC has now moved forward with its final guidance, much work remains to be done in aligning the CFTC's positions with the rules of other jurisdictions and with the SEC's rules for security-based swaps. As the rules of other regulators and other jurisdictions come into being, it will likely be necessary for market participants to seek further no-action relief and guidance from the CFTC to avoid inconsistencies and duplicative regulation. In addition, legislative action may facilitate better coordination.

As for the substance of the CFTC's final guidance, we are still in the process of reviewing the available information. While we have not seen the actual text, we would like to reiterate the critical importance of the definition of "U.S. Person" that is intended to be focused on real, direct and significant connections to the United States, rather than nominal ones. Both our asset management and dealer members remain concerned that the definition adopted by the CFTC (as described during the July 12 Open Meeting) is too ambiguous and will be too difficult to implement in practice as opposed to a simple and objective standard.[5]

Lastly, but equally significant, the CFTC has issued its final cross-border release as "guidance", rather than through a formal rulemaking process subject to the Administrative Procedure Act. By doing so, the CFTC has avoided the need to conduct a cost-benefit analysis, which is critical for ensuring that the Commission appropriately weighs any costs imposed on market participants against perceived benefits. Conversely, the SEC proposed its cross-border rules and guidance on May 1, 2013, through a formal rulemaking process emphasizing the importance of providing sufficient opportunity for public comment and the need for a cost-benefit analysis.

Last Congress, Congressmen Himes and Garrett introduced bipartisan legislation (H.R. 3283) that would provide clarity on this issue. The Himes-Garrett bill would permit non-U.S.

---

[4] See CFTC No-Action Letters 13-43; 13-44; 13-45; 13-46

[5] SIFMA Comments to CFTC Proposed Interpretive Guidance (August 27, 2012), *available at* http://www.sifma.org/issues/item.aspx?id=8589940053; SIFMA/TCH/FSR Comments to CFTC on Further Proposed Guidance (Feb. 6, 2013), *available at* http://www.sifma.org/issues/item.aspx?id=8589941955http://www.sifma.org/issues/item.aspx?id=8589941955; SIFMA AMG Comments on the Definition of U.S. Person (July 2, 2013) *available at* http://www.sifma.org/issues/item.aspx?id=8589944385

swap dealers to comply with capital rules in their home jurisdiction that are comparable to U.S. capital rules and to adhere to Basel standards. The legislation also prevents the requirement that registered swap dealers post separate margin for each jurisdiction under which they are regulated. During the 112^{th} Congress, the House Financial Services Committee acted to support this legislation by a vote of 41 to 18. SIFMA strongly supported this effort to clarify the jurisdiction of U.S. regulators.

More recently, Congressmen Garrett, Carney, and Scott introduced bipartisan legislation, the "Swaps Jurisdiction Certainty Act" (H.R. 1256), which calls for a consistent and coordinated approach to the cross-border application of Title VII by requiring the CFTC and SEC to jointly issue a rule within 270 days, and further be in accordance with the Administrative Procedures Act. Second, this measure would ensure that foreign countries with broadly equivalent regimes for swaps would not be subject to U.S. rules. Finally, this legislation requires that the Commissions jointly provide a report to Congress if they determine that a foreign regulatory regime is not broadly equivalent to United States swap requirements. This legislation was recently approved by the House of Representatives by a vote of 301-124, with broad bipartisan support. SIFMA urges that Senate Agriculture Committee to include H.R. 1256 in the CEA reauthorization legislation.

SIFMA appreciates the comments of the Senate Agriculture Committee regarding the timely implementation of swaps regulations since the passage of the Dodd-Frank Act. Chairman Stabenow has applauded CFTC efforts in addressing complex issues and consideration of public comments in response, but has also expressed concern that "after two years of deliberation, it is time to get the rules written and to fully implement this strong reform bill."[6] We also appreciate the Committee's efforts in noting the importance of coordinated and consistent rules across agencies and jurisdictions, but remain troubled by the overreach of the CFTC's cross-border guidance.

The Swap Push-Out Rule:

The Swaps Push-Out Rule, contained in Section 716 of the Dodd-Frank Act, was added to the Act at a late stage in the Senate and was not debated or considered in the House of Representatives. It would force banks to "push out" certain swap activities into separately capitalized affiliates or subsidiaries by providing that a bank that engages in such swap activity would forfeit its right to the Federal Reserve discount window or Federal Deposit Insurance Corporation ("FDIC") insurance.

The Swap Push-Out Rule has been opposed by senior prudential regulators from the time

[6] http://www.ag.senate.gov/newsroom/press/release/chairwoman-stabenow-it-is-time-to-fully-implement-wall-street-reform

it was first considered. Ben Bernanke, Chairman of the Federal Reserve, stated in a letter to Congress that "forcing these activities out of insured depository institutions would weaken both financial stability and strong prudential regulation of derivative activities."[7] Sheila Bair, former FDIC Chairwoman, said that "by concentrating the activity in an affiliate of the insured bank, we could end up with less and lower quality capital, less information and oversight for the FDIC, and potentially less support for the insured bank in a time of crisis" further adding that "one unintended outcome of this provision would be weakened, not strengthened, protection of the insured bank and the Deposit Insurance Fund."[8]

In addition to the increase in risk that would be caused by the Swaps Push-Out Rule, the limitations will significantly increase the cost to banks of providing customers with swap products as a result of the need to fragment related activities across different legal entities. As a result, U.S. corporate end-users and farmers will face higher prices for the instruments they need to hedge the risks of the items they produce. Mark Zandi, Chief Economist at Moody's Analytics, stated in a letter to Congressman Garrett that "Section 716 would create significant complications and counter the efforts to resolve [large financial] firms in an orderly manner."[9]

In January 2013, the Office of the Comptroller of the Currency (the "OCC") published guidance allowing Federally-chartered insured depository institutions to apply to delay compliance with Section 716 for up to two years.[10] On June 5, 2013, the Federal Reserve (the "Fed") approved an interim final rule clarifying that "insured depository institutions that are swaps entities" are eligible for a two year transition period to comply and for "certain statutory exceptions." The interim rule also noted that "uninsured U.S. branches and agencies of foreign banks will be treated as insured depository institutions" and thus are eligible for the same transition period.[11] Following the Fed's release the OCC notified uninsured institutions that they may also request a transition period.[12]

Bipartisan legislation, the Swaps Regulatory Improvement Act (S. 474), has been introduced by Senators Hagan, Johanns, Toomey, and Warner to modify Section 716 of the

---

[7] Letter from Ben Bernanke, Federal Reserve Chairman, to Senator Christopher Dodd (May 13, 2010), *available at* http://blogs.wsj.com/economics/2010/05/13/bernanke-letter-to-lawmakers-on-swaps-spin-off/.

[8] Letter from Sheila Bair, FDIC Chairman, to Senators Christopher Dodd and Blanche Lincoln (Apr. 30, 2010), *available at* http://www.gpo.gov/fdsys/pkg/CREC-2010-05-04/pdf/CREC-2010-05-04-pt1-PgS3065-2.pdf#page=5.

[9] Letter from Mark Zandi, Chief Economist, Moody's Corporation, to Congressman Scott Garrett (Nov. 14, 2011).

[10] http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-2a.pdf

[11] http://www.federalreserve.gov/newsevents/press/bcreg/20130605a.htm

[12] http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/706f.html

Dodd-Frank Act by requiring only structured finance swaps based on asset-back securities to be pushed out of banks and would not apply 716 to equity or commodity swaps. The net effect of these changes would be to expand permissible swap activities within a bank, and to only exclude swaps based on asset-backed securities that do not meet qualifications to be established by regulation.[13]

In the House, Congressmen Hultgren and Himes introduced bipartisan legislation (H.R. 992) identical to S. 474. On March 20, 2013, the House Agriculture Committee favorably approved this bill by a vote of 31 to 14 and on May 7, 2013 the House Financial Services Committee favorably reported the legislation by a vote of 53 to 6. SIFMA urges the Senate Agriculture Committee to include S. 474/H.R. 992 in CEA reauthorization legislation.

Swap Execution Facilities and Block Trades:

As I noted above, the Act requires certain standardized swaps to be traded on an exchange or a new platform known as a "swap execution facility," commonly called a "SEF." Congress generally defined what constitutes a SEF, but left further definition to the CFTC and SEC. To date, the CFTC has finalized its SEF regulation while the SEC has not yet acted to approve its proposed regulation.

An appropriately flexible definition of "SEF" is critical for ensuring that SEF trading requirement does not negatively impact the swap markets. Understanding this reality, the SEC has proposed a rule that would permit securities-based SEFs to naturally evolve their execution mechanisms for those securities-based swaps that are widely traded. These securities-based SEFs could be structured in many different ways, similar to how electronic trading platforms have evolved in the securities markets.

The CFTC's final rule, on the other hand, requires customers to either trade swaps on SEFs, as if they were traded on exchanges, or to solicit prices by issuing requests for quotes, generally known as "RFQs," from a minimum of three market participants for each swap subject to the SEF trading requirement.[14] This differs from current market practice where asset managers exercise their discretion, consistent with their fiduciary duties to their clients, to determine how widely to broadcast their intended trading strategies. This change could have a significant negative impact on pricing and liquidity in the swap market. By signaling to the market the desire to purchase a swap, customers may be telegraphing important information that

[13] In addition, the bill would fix a drafting error acknowledged by the Swaps Push-Out Rule's authors, under which the limited exceptions to the rule that apply to insured depositing institutions appear not to include U.S. uninsured branches or agencies of foreign banks.

[14] Traders will be required to seek quotes from a minimum of two providers during a one-year phase-in period of this rule.

may impede best execution of their orders. While we appreciate the CFTC's goal of encouraging competition among dealers to decrease the price of swaps, the reality is that this practice will do just the opposite and drive up the cost of transactions, ultimately harming the asset managers and other swap end-users this rule aims to protect. In turn, market participants may seek other means of hedging their risks and other products to trade, thereby impairing liquidity in swap markets. By imposing a standard that requires RFQs to be sent to multiple providers, the CFTC has effectively tied the hands of our asset manager members and created unnecessary adverse effects on the swap market.

Congressmen Garrett, Hurt, Meeks, and Moore sent a letter to CFTC Chairman Gensler, in April, expressing concern about the RFQ requirement and noted that an arbitrary requirement for a minimum may undermine the goal of enhancing transparency in the marketplace and would "result in deleterious effects on the marketplace, while not adding any measurable transparency benefit."[15]

In addition to the CFTC's SEF rules themselves, we believe that the CFTC's mandatory SEF trading determination, known as Made Available to Trade ("MAT"), is also flawed. Rather than setting real criteria to be met before requiring SEF execution for cleared trades, the CFTC has created a methodology by which virtually any cleared swaps can easily be required to be executed on SEFs upon listing by any SEF. Similarly, once a swap is Made Available to Trade, there is no robust methodology for reversing this determination if liquidity for trading this swap on SEFs proves to be insufficient.

Last Congress, the House Financial Services Committee supported, by voice vote, legislation that would require the CFTC and the SEC to adopt SEF rules that allow the swaps markets to naturally evolve to the best form of execution (H.R. 2586). H.R. 2586 would not require a minimum number of participants to receive or respond to quote requests and would prevent regulators from requiring SEFs to display quotes for any period of time. Finally, this bill would prevent regulators from limiting the means by which these contracts should be executed and ensuring that the final regulation does not require trading systems to interact with each other. SIFMA urges the Senate Agriculture Committee to support similar legislation in CEA reauthorization.

We also have concerns with the block trade rules that were adopted by the CFTC along with these other rules. The CFTC originally proposed block trade sizes in its proposed real-time reporting rules, but then re-proposed block trade thresholds in March 2012 after acknowledging

[15] Letter to CFTC Chairman Gary Gensler from Reps. Garrett, Hurt, Meeks, and Moore dated April 5, 2013

that its original formulation was too restrictive.[16] However, the re-proposed thresholds did not represent a significant improvement. And despite receiving a substantial number of comments from various constituencies suggesting that the CFTC refer to more recent data collected from swap data repositories, the CFTC proceeded to adopt final thresholds that are largely in line with its re-proposal. These thresholds are based on outdated data from a three-month window in 2010, prior to the imposition the CFTC's new rules including those requiring swap data reporting.

The block trade rules also include some requirements which would be disruptive and burdensome to the way that asset managers trade swaps. In particular, the rule contains a prohibition on aggregating client orders for purposes of meeting the minimum block size for managers to avail themselves of the delay from real-time reporting made available to block trades under Title VII. Although this prohibition does contain an exception, the language is ambiguous with respect to large trades that are executed off of SEFs. These trades are exempted from mandatory SEF trading by the CFTC in order to avoid information leaking in to the marketplace and being used opportunistically by other traders before the block trade can be finalized. If asset managers are not permitted to aggregate client orders, as they do today, for purposes of the real-time reporting delay, then their trading information may not be adequately protected from front running. In addition, asset managers will now be required to obtain specific consents from clients for including their swaps within block trades, creating additional unnecessary work for managers at a time when they are already heavily burdened by implementing the new swap rules. Aggregation of client orders in block trades is typically disclosed by investment advisers to their clients.

Basel III:

Implementation of the Basel III capital standards accord is an area of great interest and concern for our members and the financial services industry as a whole. The industry is in strong support of efforts to promote consistent international standards.

Accordingly, Congressman Fincher introduced the Financial Competitive Act, (H.R. 1341), that would direct the Financial Stability Oversight Council (FSOC) to examine differences in the implementation of derivatives capital requirements and the CVA. Further, the bill would require FSOC to assess the effects on the U.S. financial system and to make recommendations to minimize any negative impact on U.S. financial firms and end-users. This legislation was favorably reported to the House Financial Services Committee by vote of 59 to 0 and was recently approved by the House of Representatives by a vote of 353 to 24. SIFMA

[16] Procedures To Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, 77 Fed. Reg. 15,460 (Mar. 15, 2012) (amending 17 CFR Part 43).

urges the Senate Agriculture Committee to include H.R. 1341 in CEA reauthorization legislation.

Margin Requirements:

The CFTC is currently considering rulemaking detailing margin requirements for uncleared swap transactions. The Commission originally proposed rules during the summer of 2011, and later reopened its comment period in light of consultative guidance from the Basel Committee on Banking Supervision ("BCBS") and International Organization of Securities Commissions ("IOSCO") released during the summer of 2012 (a second consultation was released in February 2013). Many market participants have expressed great concern over the various regulatory proposals regarding initial margin requirements. SIFMA has urged regulators to utilize daily variation margin requirements to meet G20 efforts aimed at reducing systemic risk and increasing market stability, while avoiding the imposition of onerous mandatory initial margin requirements, which would drain liquidity and have negative pro-cyclical impacts on markets during times of stress.[17] We have urged the CFTC to formally re-propose its margin rule proposal based on the final BCBS-IOSCO report that is expected in September. SIFMA urges the Senate Agriculture Committee to consider SIFMA's comments regarding proposed margin requirements for uncleared swaps in the CEA reauthorization legislation.

Cost-Benefit Analysis:

As noted above, it is critical that regulators carefully balance the benefits of swap-related regulation with the potential decreases in liquidity and increased costs to customers wishing to hedge their activities. As a result, throughout the Title VII rulemaking process, SIFMA has encouraged regulators to conduct comprehensive cost-benefit analysis for all Dodd-Frank rules.

This is consistent with the Obama Administration's efforts to promote better cost-benefit analysis for federal agencies through Executive Order 13563,[18] which requires all agencies

[17] SIFMA has responded to various regulatory proposals on initial margin requirements. These include responses to the CFTC's re-opened comment period on proposed rules on margin for uncleared swaps, submitted Sept. 14, 2012; http://www.sifma.org/issues/item.aspx?id=8589940303), and to the first and second BCBS/IOSCO consultative documents on margin requirements for non-centrally cleared derivatives, submitted Sept. 28, 2012 (http://www.sifma.org/issues/item.aspx?id=8589940507) and March 15, 2013 (https://www.sifma.org/issues/item.aspx?id=8589942551), respectively. SIFMA has also provided comments in response to SEC (http://www.sifma.org/issues/item.aspx?id=8589942116) and U.S. Prudential Regulator proposals (http://www.sifma.org/issues/item.aspx?id=8589941054) on margin requirements for uncleared swaps.

[18] http://www.whitehouse.gov/the-press-office/2011/01/18/improving-regulation-and-regulatory-review-executive-order

proposing or adopting regulations to include cost-benefit analyses in an attempt to minimize burdens, maximize net benefits and specify performance objectives. The President also stated that regulations should be subject to meaningful public comment, be harmonized across agencies, ensure objectivity and be subject to periodic review. In 2012, in testimony before the House Committee on Government Reform, the SEC Chairman Schapiro stated "I continue to be committed to ensuring that the Commission engages in sound, robust economic analysis in its rulemaking, in furtherance of the Commission's statutory mission, and will continue to work to enhance both the process and substance of that analysis."[19]

Congressmen Conaway has introduced legislation (H.R. 1003) that would improve the consideration by the CFTC of the costs and benefits of its regulations and orders by requiring the Commission to "assess the costs and benefits, both qualitative and quantitative, of the intended regulation and propose or adopt a regulation only on a reasoned determination that the benefits of the intended regulation justify the costs of the intended regulation" and "shall evaluate considerations of the impact on market liquidity in the futures and swaps markets". SIFMA strongly supports H.R. 1003 and urges the Committee to support this vital initiative that would enhance cost-benefit analysis done by the CFTC.

Thank you for giving me this opportunity to explain our views related to several important measures to be considered by the Senate Committee on Agriculture.

[19] http://www.sec.gov/news/testimony/2012/ts041712mls.htm

Testimony before the U.S. Senate Committee on Agriculture, Nutrition & Forestry

"Reauthorization of the Commodity Futures Trading Commission"

Jim Colby
Assistant Treasurer,
Honeywell International Inc.

July 17, 2013

Chairwoman Stabenow, Ranking Member Cochran, and other members of the Committee, thank you for inviting me to testify at this important hearing. I am an assistant treasurer at Honeywell International and today I speak on behalf of Honeywell, the Coalition for Derivatives End-Users and other commercial end-users who are asking Congress to take quick action on S.888 to provide non-financial end-users hedging commercial risk an exception from margin requirements in keeping with the original intent of the Dodd-Frank Act.

Honeywell is a diversified technology and manufacturing leader, serving customers worldwide with aerospace products and services; control technologies for buildings, homes and industry; turbochargers; and performance materials. Honeywell's growth is driven by technologies that address some of the world's toughest challenges such as energy efficiency, clean energy generation, safety & security, globalization and customer productivity. The company's more than 132,000 employees include 20,000 scientists and engineers who are focused on developing innovative products and solutions that help Honeywell's customers – and their customers – improve performance and productivity.

Honeywell is truly a global company, with more than 50 percent of our sales outside of the United States and therefore exposed to market risks from changes in interest rates, foreign exchange rates and commodity prices. When appropriate, we hedge exposures through the use of derivative contracts. The purpose of our hedging activities is to eliminate risks that we cannot control, allowing us to focus on our core strengths, namely delivering high-quality products, on time, to our customers in a manner that not only meets, but exceeds expectations. We do not use derivatives for speculative purposes.

With regulators expected to finalize margin rules and a compliance deadline for end-users before the end of the year, Honeywell and other non-financial end-users ask the Senate to take quick action on S. 888 to end the uncertainty facing our companies and prevent the resulting negative economic impacts. Without swift action by the Senate on this legislation, which passed the House with an overwhelming bipartisan vote in June, non-financial end-users will be forced to divert capital away from job creating investments, sidelining billions of dollars in margin accounts. According to a Coalition for Derivatives End Users survey, a 3% initial margin requirement could reduce capital spending by as much as $5.1 to $6.7 billion among S&P 500 companies alone and cost 100,000 to 130,000 jobs.

To demonstrate how non-financial end-users use derivatives to effectively manage risk I will provide some examples of how Honeywell uses derivatives. We sell satellite and launch vehicle inertial measurement units manufactured in Florida to customers in Germany. Europe is a key growth market for commercial space products and, in order to qualify for consideration on certain opportunities, we may be required to enter into contracts denominated in Euros even though all costs of production are incurred in U.S. Dollars. The period for this type of contract can span multiple years, during which changes in the value of the Euro versus the U.S. dollar can significantly impact its economics. To mitigate this risk, we may enter into a forward contract to sell an amount of Euros equal to our net exposure to lock in the market rate.

Honeywell carefully manages its ratio of fixed-to floating rate debt in order to lower its overall cost of debt, while providing sufficient interest rate certainty to accurately forecast and manage interest expense. Floating rate debt has historically been cheaper than fixed-rate debt, but cannot be easily issued in longer maturities, thereby exposing Honeywell to refinancing risk. Honeywell uses interest rate derivatives to convert a portion of its fixed-rate debt to floating, thereby creating a synthetic floating rate note with a longer-term maturity than can be issued directly in the capital markets.

To shed some light on Honeywell's potential exposure to margin requirements, we had approximately $2 billion of hedging contracts outstanding at year-end that would be defined as a swap under Dodd-Frank. Applying 3% initial margin and 10% variation margin implies a potential margin requirement of $260 million. Cash deposited in a margin account cannot be more productively deployed in our businesses and as a result limits our ability to promote economic growth and protect American jobs.

In approving the Dodd-Frank Act, Congress made clear that end-users were not to be subject to margin requirements. Nonetheless, regulations proposed by the Prudential Banking Regulators could require end-users to post margin. This stems from what they view to be a legal obligation under Title VII, not because they view it as necessary for the safety and soundness of the financial system.

A dialogue between Senator Mike Crapo and Federal Reserve Chairman Ben Bernanke at the Senate Banking Committee on July 17, 2012 and a subsequent one between Senator Tester and Governor Daniel Tarullo last week underscore why passage of the margin bill is necessary and why the Senate should have confidence in taking quick action. As Governor Tarullo made clear last week, passage of this bill would simply remove what they believe to be the requirement under Dodd-Frank to impose margin requirements while leaving intact the "ability to use [the] full panoply of supervisory tools." He further stated that the Fed does not need any additional authority to promote safety and soundness in the financial system and good risk management practices among regulated entities. Passage of S.888 would not remove the ability of banks to set margin requirements on end-users as part of their credit risk management practices.

This legislation in no way begins to dismantle Dodd-Frank. It would simply ensure that the final Act and rules function as Congress intended and that commercial end-users do not face the same regulatory burden as those who speculate and create systemic risk. Commercial end-users were not the cause of the financial crisis. In fact, they were a safe-haven during the financial turmoil. Investors who were afraid to invest in the debt of financial institutions were actively purchasing the debt of companies like Honeywell, companies that prudently use derivatives to manage and reduce risk and who continued to be profitable throughout the financial crisis, with no need for government assistance.

I also would like to raise an issue relating to centralized treasury units. The issue does not currently impact Honeywell but is of great importance to a number of end-users. Many companies employ centralized treasury units so that they have a single or small number of entities transacting with swap dealer counterparties. These "CTUs" allow companies to centralize their expertise, net down the types and number of external facing trades, and achieve better pricing. The problem is, this treasury "best practice" can deny a company the end-user clearing exception because a CTU could be considered a financial entity, even if it is an affiliate of a purely non-financial end-user. End-users are seeking support in the Senate for the introduction of a bill to clarify that if a CTU is part of a non-financial end-user and is hedging commercial risk, then the trade would be eligible for the end-user clearing exception in the Dodd-Frank Act.

In conclusion, we need the Senate to quickly enact legislation so that end-users like Honeywell will continue to have the ability to manage risk without having mandatory and unnecessary margin requirements imposed. Mandatory requirements would divert cash from investment and job creation. Regulators have made clear that they are not necessary for the safety and soundness of our financial system.

Thank you for inviting me to testify today. We ask the members of the Committee to support quick action on S.888. I look forward to answering any questions that you may have.

MANAGED FUNDS ASSOCIATION

WRITTEN STATEMENT

OF

ADAM COOPER
SENIOR MANAGING DIRECTOR AND CHIEF LEGAL OFFICER,
CITADEL LLC

ON BEHALF OF
MANAGED FUNDS ASSOCIATION

For the Hearing
Reauthorization of the Commodity Futures Trading Commission

BEFORE THE

U.S. SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

JULY 17, 2013

600 14th Street, NW, Suite 900 Washington, DC 20005 Phone: 202.730.2600 Fax: 202.730.2601 www.managedfunds.org

My name is Adam Cooper and I am Senior Managing Director and Chief Legal Officer of Citadel LLC, a global financial institution that engages in a wide range of asset management activities on behalf of institutional investors, as well as capital markets activities on behalf of retail and institutional investors, around the world. We are one of the largest and most established asset managers in the industry, growing capital for our investors around the world for nearly 25 years. And Citadel Securities is a leading market maker, simplifying complex markets and providing liquidity and execution services on behalf of millions of retail investors since 2005. Based in Chicago, we operate globally through the world's financial centers, including New York, London, Hong Kong, San Francisco and Boston.

I am here today to speak on behalf of Managed Funds Association ("**MFA**") and its members. On their behalf, I am pleased to provide this statement in connection with the U.S. Senate Committee on Agriculture, Nutrition and Forestry's hearing held on July 17, 2013 on Reauthorization of the Commodity Futures Trading Commission (the "**CFTC**"). MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. MFA's members manage a substantial portion of the approximately $2.375 trillion invested in absolute return strategies around the world. Our members serve pensions, university endowments, and other institutions.

MFA's members are among the most sophisticated institutional investors and play an important role in our financial system. They are active participants in the commodity and securities markets, including over-the-counter ("**OTC**") derivatives markets. They provide liquidity and price discovery to capital markets, capital to companies seeking to grow or improve their businesses, and important investment options to investors seeking to increase portfolio returns with less risk, such as pension funds trying to meet their future obligations to plan beneficiaries. MFA members engage in a variety of investment strategies across many different asset classes. The growth and diversification of investment funds have strengthened U.S. capital markets and provided investors with the means to diversify their investments, thereby reducing overall portfolio investment risk. As investors, MFA members help dampen market volatility by providing liquidity and pricing efficiency across many markets. Each of these functions is critical to the orderly operation of our capital markets and our financial system as a whole.

MFA appreciates the Committee's thoughtful review and focus on CFTC Reauthorization. After three years of rulemaking to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**"), the new regulatory landscape is now taking shape. MFA supported financial reform and policymakers' goals to improve the functioning of the markets and to protect customers by endorsing central clearing of derivatives, increasing transparency and implementing other measures intended to mitigate systemic risk. We believe some additional refinements to the Commodity Exchange Act ("**CEA**") should be made to further fulfill these objectives and to enhance regulatory protections, coordination and efficacy.

In these respects, we believe Congress should: (1) amend the Bankruptcy Code to help shield derivatives customers from another MF Global or Peregrine-like failure by enhancing protections of customer collateral; (2) improve and streamline oversight of commodity pool operators ("**CPOs**") and commodity trading advisors ("**CTAs**"); (3) amend the CEA by adopting stronger protections for confidential information; (4) encourage data-driven regulations concerning position limits; and (5) continue to encourage international coordination on the global regulation of derivatives through its oversight of the CFTC and through Congress's international diplomacy.

On behalf of MFA, we appreciate the Committee's consideration of this testimony. As active participants in the derivatives markets, we are committed to working with the Congress, the CFTC, and other interested parties in addressing issues for CFTC Reauthorization.

PROTECTION OF CUSTOMER COLLATERAL

Protection of Cleared Swaps Customer Collateral

MFA supports efforts to strengthen the legal framework applicable to collateral for customers related to cleared swaps transactions with futures commission merchants ("**FCMs**") and believes that Congress should amend the Bankruptcy Code to bolster such protection.

MFA appreciates that Congress remains vigilant about protection of investors and has held hearings related to the MF Global, Inc. ("**MF Global**") and Peregrine Financial Group, Inc. ("**Peregrine**") insolvencies. Our members are fiduciaries to their investors and are customers themselves. As a result, we remain deeply troubled by the MF Global and Peregrine events and the consequences of their insolvencies. The misuse or misplacement of customer funds in those situations resulted in customers experiencing a delay, in some cases a significant delay, in the return or outright loss of substantial amounts of their assets. The protection of customer funds is one essential element to preserving the financial integrity of the markets. Accordingly, we support thoughtful legislative and regulatory changes to strengthen protections of FCMs' customers trading cleared swaps.

Under current law, if an FCM becomes insolvent, all of the collateral of the FCM's cleared swaps customers would be aggregated and distributed to each customer on a *pro rata* basis. Therefore, even when a customer was not at fault, if there is an insufficient amount of cleared swaps customer collateral available in the FCM's customer account to repay all customers who posted collateral, the customer would lose a portion of its posted collateral. To remedy this concern, we urge Congress to amend Chapter 7 of the Bankruptcy Code so that, upon an FCM's insolvency, customer assets posted as collateral on cleared swaps transactions would not be subject to *pro rata* distribution.

Such an amendment would ensure that cleared swaps customers do not share in any shortfall due to the FCM's or another customer's default.

An amendment to the Bankruptcy Code also would enhance the effectiveness of existing and potential segregation protections for cleared swaps customers. For example, the CFTC has adopted the "legally segregated operationally commingled" model ("**LSOC**") for cleared swaps, which should generally reduce the likelihood of there being a customer asset shortfall in certain FCM default scenarios. However, LSOC is a new segregation model, so there is some uncertainty as to how it will perform in an FCM insolvency. An amendment to the Bankruptcy Code, as discussed above, would alleviate this uncertainty and further assure the protection of non-defaulting customers in certain FCM default situations.

In addition, market participants are continuing to consider other enhancements to customer protections, such as optional full physical segregation of customer collateral. This arrangement would allow a customer to put its collateral in an account with a custodian or other third party in the customer's name, rather than have the customer's FCM hold its collateral directly, and thus, protects the customer in the event that its FCM or another customer becomes insolvent. Without a Bankruptcy Code amendment, however, a cleared swaps customer's physically segregated collateral might be considered part of the pool of customer assets of the insolvent FCM, and thus, distributed on a *pro rata* basis. Therefore, MFA believes that, if Congress amended the Bankruptcy Code, it would significantly enhance customer protection.

Protection of Futures Customer Collateral

In light of the MF Global and Peregrine failures, MFA feels it is also appropriate for the CFTC to re-examine the protections available to participants in the futures market, and to assess the appropriate balance between the costs of enhanced protections versus the costs to investors and the market as a whole of a segregation failure. As mentioned, we appreciate that the CFTC is working on proposals to enhance customer protections. As a further step, we think that the Committee should encourage the CFTC to hold one or more roundtables, as the CFTC did when considering segregation rules for cleared swaps, to ensure full consideration of the lessons learned, and to assess whether further protections of the collateral of futures customers are appropriate.

OVERSIGHT OF COMMODITY POOL OPERATORS

Re-Focusing CPO Registration

MFA believes that Congress should amend the CEA to focus CPO regulation on entities that are meaningfully engaged in trading commodity interests. More specifically, MFA believes that the CFTC's regulatory resources should be focused on CPOs that are "engaged primarily" in or formed "for the purpose of trading commodity interests," rather than stretched to cover already regulated investment entities whose trading in commodity interests is incidental to their primary trading activities in other financial instruments or that have indirect commodity interest exposure.

It is clear that the Dodd-Frank Act in amending the definition of commodity pool and CPO to include swaps transactions broadened the CFTC's registration mandate. On the other hand, we believe the CFTC's repeal of Regulation 4.13(a)(4), the CPO registration exemption for a CPO of a private pool, overly broadened the registration requirement such that investment entities that were not originally established to function as registered CPOs are now subject to the CFTC's regulatory scheme. As a result, the CFTC and National Futures Association ("**NFA**") must now spend even greater resources addressing regulatory issues with respect to entities: (i) whose business models do not fit the commodity pool regulatory framework; (ii) whose trading in commodity interests are incidental to their primary trading activities in other financial instruments; (iii) that are currently subject to different regulatory regimes; or (iv) that have indirect exposure to commodity interests.

These entities include investment advisers registered with the Securities and Exchange Commission ("**SEC**"), securitization vehicles, real estate investment trusts, private equity firms, fund-of-funds, family offices, foreign pool operators and business development companies. The CFTC's repeal of Regulation 4.13(a)(4) generated a substantial number of requests for interpretive and compliance relief as investment managers and other entities struggled to rationalize and adapt to different, overlapping regulatory regimes. MFA submitted numerous requests to the CFTC for clarifications, no-action or interpretive relief, petition for rulemaking, and guidance on the application of a regulatory regime not tailored to many of its new constituencies. Many of our requests are outstanding and we continue to work on new requests for regulatory relief.

The CFTC's CPO regulations require entities to register if they have indirect commodity interest exposure or even if their use of commodity interests is limited for hedging purposes. As a consequence, many SEC-registered investment advisers of fund-of-funds and private investment funds that do not trade commodity interests or that use commodity interests for limited purposes, such as hedging, are required to register with the CFTC as a CPO.

We believe the CEA does contemplate a broader exemption from CPO registration. The CEA provides that "[t]he term 'commodity pool' means any investment trust, syndicate, or similar form of enterprise ***operated for the purpose of trading in commodity interests***," (***emphasis added***). Also, Section 4m(3) of the CEA introduces the concept of "engaged primarily" with respect to CTA registration, and excepts a CTA that is:

> registered with the Securities and Exchange Commission as an investment adviser whose business does not consist ***primarily of acting*** as a commodity trading advisor, as defined in section 1a, and that does not act

> as a commodity trading advisor to any commodity pool that is ***engaged primarily*** in trading commodity interests (***emphasis added***).

Section 4m(3)(B) of the CEA provides that:

> a commodity trading advisor or a commodity pool shall be considered to be "engaged primarily" in the business of being a commodity trading advisor or commodity pool if it is or holds itself out to the public as being engaged primarily, or proposes to engage primarily, in the business of advising on commodity interests or investing, reinvesting, owning, holding, or trading in commodity interests, respectively.

Given that regulatory resources are limited, we believe Congress should direct the CFTC to focus registration oversight of CPOs on entities that are engaged primarily or operated for the purpose of trading commodity interests rather than overseeing entities whose trading in commodity interests are incidental to their primary trading activities in other financial instruments or that have indirect exposure to commodity interests. To be clear, we are not asking this Committee to overturn in its entirety the CFTC's repeal of Regulation 4.13(a)(4). Instead, we suggest that the repeal is overly broad. Accordingly, we recommend that Congress amend the CEA by providing a registration exemption for operators of entities that are not engaged primarily in trading commodity interests or formed for the purpose of trading commodity interests.

CFTC-SEC Coordination on Regulation Pertaining to Private Fund Operators/Advisors

As a majority of the new CPO registrants are registered investment advisers of private funds, we believe Congress should direct the CFTC and SEC to streamline regulations for operators of private funds and to ensure consistency among regulations. We are concerned that the differences between the CFTC's and the SEC's regulatory frameworks for operators/advisers of private funds creates a significant burden on the private fund industry.

For example, despite the fact that the Dodd-Frank Act directs the CFTC and the SEC to promulgate a joint systemic risk report, a private fund manager registered as an investment adviser, CPO and CTA faces three different reporting obligations—

(i) filing Form PF with the SEC;

(ii) filing Form CPO-PQR and CTA-PR with the CFTC; and

(iii) filing quarterly PQR and PR reports with NFA.

The SEC and CFTC forms request similar (though not identical) information but direct it be compiled by different methodologies. Moreover, we are concerned that the information collected will not be helpful to FSOC's Office of Financial Research in assessing systemic risk because the data required by the CFTC and the SEC are different and cannot be aggregated.

Another example of an important dichotomy between the CFTC and the SEC's regulations at the moment relates to the enactment of the Jumpstart Our Business Startups Act of 2012 ("**JOBS Act**"). The JOBS Act directed the SEC to amend the securities regulations to eliminate the prohibition on general solicitation and advertising with respect to private offerings under Regulation D, which apply to both privately-offered investment funds and commodity pools. The SEC has adopted rules pursuant to the JOBS Act, however, the CFTC's CPO regulations are now inconsistent with the JOBS Act and the securities regulations. We believe this situation creates an unreasonable dichotomy between the regulation of advisers of private funds and CPOs of privately-offered commodity pools.

We believe the regulation of private fund managers between the CFTC and SEC should be consistent. Accordingly, we recommend that Congress direct the CFTC and the SEC to collaborate in ensuring that their private fund regulations are consistent.

STRENGTHENING PROTECTIONS FOR CONFIDENTIAL/PROPRIETARY INFORMATION

Reports of Commodity Pool Operators and Commodity Trading Advisors

MFA believes that Congress should strengthen the confidentiality protections for proprietary data in the CFTC's possession. MFA consistently has supported reasonable reporting requirements to ensure that regulators have meaningful data upon which to make sound policy decisions, but it is critically important that our members know that in fulfilling their reporting obligations, their proprietary portfolio and other confidential information is appropriately safeguarded. Market participants—whether hedgers or investors—invest significant research, time and resources into developing proprietary hedging or investment strategies. Such trading strategies are proprietary information; the CEA and other statutes have recognized the legitimate commercial need to protect the confidentiality of such information.

At the same time that the Dodd-Frank Act required members of the Financial Stability Oversight Council ("**FSOC**"), including the CFTC, to collect sensitive and confidential data for the purpose of assessing financial stability, it also included important provisions directing FSOC members to maintain the confidentiality of such data. The Dodd-Frank Act specifically amended the Investment Advisers Act of 1940 ("**Advisers Act**") to protect the confidentiality of reports that the SSEC requires for SEC-registered investment advisers, but no corresponding amendments were made to the CEA for CFTC reports. Such amendments would be appropriate to ensure that consistent confidentiality protections would extend to the reports, documents, records and sensitive and proprietary information of CPOs and CTAs.

The current inconsistency between the confidentiality protections afforded to reports by investment advisers as opposed to reports by CPOs and CTAs creates two potential difficulties. First, it may expose data from CFTC-regulated entities to greater risk of public disclosure. Second, it creates a potential unlevel regulatory playing field, disadvantaging the CFTC in its efforts to collect, analyze, and share data. For example, we note that the SEC and CFTC have jointly adopted Form PF for certain reporting obligations. A dually registered entity filing Form PF with the SEC would have greater confidentiality protection than if the entity filed the exact same report with the CFTC. To afford confidential information consistent treatment for CPOs and CTAs as well as investment advisers, we recommend that the Committee consider amending section 8 of the CEA by extending these important Dodd-Frank Act protections for sensitive or proprietary information to CPOs and CTAs.

Protection of the Identity of Traders and the Confidentiality of Trade Data

MFA believes that Congress should amend the CEA to strengthen the confidentiality requirements for registered swap data repositories ("**SDRs**") and other regulated market utilities, such as self-regulatory organizations, swap execution facilities ("**SEFs**"), designated contract markets ("**DCMs**"), and derivatives clearing organizations or clearinghouses ("**CCPs**") (collectively, "**Regulated Entities**") to protect both the identity of traders and the nature of their trading activities. In particular, these confidentiality protections must explicitly extend to swap transaction data reported to SDRs under the CFTC's data reporting rules. Our concern is not hypothetical; we are aware of instances where the confidentiality of trade data at SDRs was compromised. As a result of the failure of confidentiality protections, market participants may have had access to, and could have traded upon, confidential information of competitors and counterparties.

The specifics giving rise to these concerns are best illustrated under the CFTC's final SDR rules, wherein it is clear that an SDR must protect the confidentiality of reported swap data and may not disclose it to market participants. However, the same rules provide an exception to this prohibited access rule, allowing a party to a particular swap to have access to "data and information" related to such swap. The final SDR rules do not define the broad phrase "data and information."

For swaps that are traded anonymously on DCMs and SEFs and then cleared in accordance with the CFTC's straight-through processing ("**STP**") requirements, the CCP or DCM/SEF reports the swap transaction data and information to the SDR, which includes the identity of the two original counterparties. If either one of those counterparties is then permitted to discover the identity of the other by accessing information at the SDR, notwithstanding the anonymous nature of the original trade, the confidentiality of that market participant's trading positions and/or investment strategies is breached. Such disclosure would harm competition, and would impair the smooth transition to anonymous trading on DCMs and SEFs.

Another source of data disclosure risk stems from the sheer volume of data that the CFTC is now processing and analyzing from SDRs. While the CFTC's access to such data no doubt presents an opportunity for unprecedented regulatory insight into the derivatives markets – which we support – we are also mindful that it creates another source of disclosure risk if data confidentiality and integrity are not rigorously protected by the CFTC's policies, procedures and internal controls.

Accordingly, MFA recommends that Congress amend the CEA to clarify the CFTC's and each Regulated Entity's obligations to maintain the confidentiality and integrity of swap trade data and the consequences of failures to perform this obligation. MFA further urges the Committee to use its oversight to ensure that both the CFTC and Regulated Entities have appropriate safeguards to preserve the confidentiality of sensitive market information and data furnished to regulators and Regulated Entities.

Finally, we are alarmed at reports from this spring that academics have had access to confidential trading data and trading messages from the CFTC. According to these reports, the academic used this information to reverse-engineer trading strategies and published their findings in academic journals. We commend CFTC Chairman Gary Gensler for requesting that the CFTC Inspector General investigate this matter. We believe this disclosure is a fundamental violation of confidentiality and urge the Committee to review the CFTC Inspector General's findings and the steps the CFTC agrees to take to enhance its policies and controls with respect to non-public information.

MFA has prepared a *White Paper* outlining its concerns regarding protection of confidential information and submitted it to all members of the Financial Stability Oversight Council. We include a copy of that *White Paper* as an Appendix to our testimony.

POSITION LIMITS

MFA urges the Committee through its oversight function to carefully assess any new CFTC efforts to impose position limits more broadly pursuant to the Dodd-Frank Act. MFA continues to have significant reservations about the efficacy of position limits to benefit the public. Academic and governmental studies and real world examples: (i) have not found excessive speculation to be the cause of market volatility in recent years, and (ii) show that policies restricting investor access to derivatives markets impair the ability of commercial participants to manage risk.[1] Nonetheless, we have sought to work

[1] *See* CFTC Inter-Agency Task Force on Commodity Markets—Interim Report on Crude Oil (July 2008); GAO Briefings to the House Committee on Agriculture on Issues Involving the Use of Futures Markets to Invest in Commodity Indexes (Dec. 2008); International Organization of Securities Commission's Technical Committee (IOSCO) Final Report (Mar. 2009); IMF World Economic Outlook (Oct. 2008); HM Treasury Global Commodities: A long term vision for stable, secure and sustainable global markets (June 2008); CME Group white paper "Excessive Speculation and Position Limits in Energy Derivatives Markets," available at http://cmegroup.com/company/files/PositionLimitsWhitePaper.pdf; *Dr Evil, or drivel? The charge-sheet against commodity speculators is flimsy*, Economist, November 11, 2010 ("In fact there is little empirical evidence that

constructively with the CFTC on its efforts to implement position limit rules more broadly to energy and metal commodities.

We believe that the CFTC, in promulgating position limit rules, should do so based on detailed quantitative data and analysis reflecting, among other things, the size and depth of markets. We are concerned that inappropriate limits could reduce hedging activity, decrease market liquidity, and artificially raise commodity prices. While the CFTC collects this data, we believe position limits should be limited to the spot month where the deliverable supply of the commodity may be limited and, thus, subject to control and manipulation.

Under current position limit rules for agricultural commodities, the CFTC provides relief from having to aggregate accounts or positions based on ownership where discretion over trading is granted to an independent third party. This accurately reflects the fact that the beneficial owners in these cases do not directly or indirectly control the trading of the accounts or positions involved, and they are often unaware of the specific orders. If the CFTC does choose to adopt position limit rules for commodities more broadly, we believe that persons with independently controlled accounts should be able to treat such accounts separately and not aggregate the positions of such accounts for position limit purposes. Oftentimes, a fund may have ownership interests in other funds, accounts or enterprises for which it does not control or have position level transparency; or a fund may engage in multiple independent investment or trading strategies. If the CFTC adopts new rules on position limits, it should retain its longstanding disaggregation policy for independent account controllers.

We respectfully urge the Committee to encourage the CFTC to take a data-driven approach in setting position limits if it finds that limits are appropriate. This will minimize the possibility of unintended consequences, such as the reduction of market liquidity and the inability of market participants to appropriately diversify and hedge risk.

---

investors cause more than fleeting distortions to commodity prices. The most persuasive explanation for the rises and falls of commodities is demand and supply."); Irwin, Scott. H., and Sanders, Dwight R. (2010), The Impact of Index and Swap Funds on Commodity Futures Markets: Preliminary Results, OECD Food, Agriculture and Fisheries Working Papers, No. 27, OECD Publishing; "With Better Data, Better Understanding" (Jan. 27, 2009); Lawrence Eagles, J.P. Morgan; CFTC Staff Report on Commodity Swap Dealers & Index Traders (Sept. 2008); "Commodity Price and Futures Positions" (Dec. 16, 2009), Ruy Ribero, Lawrence Eagles and Nicholas von Solodkoff, J.P. Morgan; "We can safely say there is no indication in this data of the fact speculators are pushing the price of oil," Christophe Barret, global oil analyst at Credit Agricole, quoted in Energy Risk (Apr 13, 2010), available at http://www.risk.net/energy-risk/news/1600919/cftc-speculators-influence-commodity-markets; Prepared Testimony of Philip K. Verleger, Jr., Haskayne School of Management, University of Calgary, PKVerleger LLC, to Commodity Futures Trading Commission on The Role of Speculators in Setting the Price of Oil (Aug. 5, 2009); "Speculators Cleared in U.K. Oil Volatility" (July 28, 2009), *The Wall Street Journal*; CFTC Interagency Task Force on Commodity Markets, Interim Report on Crude Oil, *supra* note 11; and Büyükşahin, Haigh, Harris, Overdahl and Robe, Fundamentals, Trader Activity and Derivative Pricing (December 4, 2008), available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/marketreportenergyfutures.pdf.

600 14th Street, NW, Suite 900 Washington, DC 20005 Phone: 202.730.2600 Fax: 202.730.2601 www.managedfunds.org

INTERNATIONAL ASPECTS OF REGULATION

International Coordination

MFA urges U.S. policymakers and regulators to continue to enhance their coordination with their European, Asian, and other counterparts to ensure that derivatives regulatory reform is consistent, where applicable, and addresses counterparty and systemic risk, while permitting access to, and competition among, CCPs. We appreciate the recent agreement between the CFTC and the European Commission ("**EC**") on a "common path forward" on regulation of cross-border swaps. We think it reflects positive collaboration, and we continue to review and develop our views on its substance.

As the Committee is aware, European, Asian, and other policymakers are currently finalizing or beginning to implement their regulatory reforms with respect to OTC derivatives. While MFA expects these regulations to complement the U.S. market reform to a certain extent, the scope is not identical to the U.S. regulations and they are proceeding at different paces. Therefore, we are concerned that, without sufficient coordination and harmonization as to timing and scope of these different initiatives, conflicting rules will impair the derivatives market.

For example, with respect to margin requirements for uncleared derivatives, MFA strongly believes that an internationally uniform set of margin requirements is necessary and will facilitate orderly collateral management practices and minimize regulatory arbitrage. MFA applauds the formation of the Working Group on Margining Requirements of the Basel Committee of Banking Supervision and the International Organization of Securities Commissions to develop a unified international framework for margining uncleared derivatives. In the absence of such uniformity, market participants, including MFA members, will have to monitor and comply with multiple margin regimes, which would be administratively difficult, costly and burdensome, and may increase the likelihood for errors and instances of non-compliance.

Similarly, STP is a critical aspect of mandatory clearing that requires CCPs to accept or reject trades that dealers submit for clearing as quickly as technologically practicable. STP is important because it provides counterparties with immediate certainty as to whether or not their trade has cleared and whether they will face the CCP as their counterparty rather than each other. The CFTC has exhibited strong leadership and has finalized and implemented STP rules. In addition, European authorities have included a similar STP mandate in the Council Text of the Markets in Financial Instruments Directive (2004/39/EC), and the CFTC, EC and the European Securities and Markets Authority recently agreed to continue to work together on similar approaches to STP. We believe it is necessary for STP to become an international mandate to ensure: (i) market participants' ability to reduce their global counterparty credit risk without delay; (ii) market participants' unrestricted access to the broadest range of executing counterparties; and (iii) liquidity and competitive pricing of derivatives transactions.

Lastly, it is important that approval by U.S. and non-U.S. regulators of CCPs organized outside their jurisdiction (*i.e.*, third country CCPs) not become unreasonably difficult to obtain. Because of mandatory requirements for clearing of derivatives, it is important to ensure that market participants have sufficient access to, availability of, and competition among, CCPs organized in U.S. and non-U.S. jurisdictions. Otherwise, there is potential that the derivatives market will become fragmented along jurisdictional lines, which could significantly harm the markets by, among other things, impeding competition, impairing portability, limiting participant access to clearing, and ultimately creating artificial barriers across a global marketplace and instrument type.

While MFA recognizes that the regulatory regimes of different countries may need to diverge to a certain extent to reflect local concerns, inconsistent regulations will be costly, burdensome and, in some cases, make it impossible for market participants to comply with both regimes. We are appreciative of the ongoing joint efforts of U.S. and non-U.S. policymakers and regulators to avoid any disharmony, duplication or conflicts between the regulations. We urge the Committee to continue to encourage international coordination on the global regulation of derivatives through its oversight of the CFTC and through Congress's international efforts.

Extraterritorial Application of International Regulations

MFA encourages U.S. and non-U.S. regulators to harmonize the extraterritorial scope and substituted compliance frameworks of their derivatives regulatory regimes. The extraterritorial application of the U.S. and non-U.S. derivatives regulations (particularly the European Markets Infrastructure Regulation) remains a significant area of focus and concern for MFA. Unfortunately, considerable uncertainty continues to exist with regard to this issue. We appreciate the need to ensure that where a market participant's activities have a direct and significant effect on a jurisdiction, that market participant is subject to adequate regulation in that jurisdiction. However, because the derivatives market is a global market, market participants and their transactions will be subject to regulation in multiple jurisdictions. Thus, we urge continued harmonization of these regulations to ensure that the extraterritorial scope of the various international reforms will not be duplicative and that related substituted compliance regimes will give sufficient deference to comparable regulations. We believe it important to ensure that, together, the final regulations will provide certainty to market participants, ensure the continued robustness of the derivatives markets and further the progress of international harmony and consistency.

As mentioned previously, we appreciate the CFTC's and EC's recent agreement on a "common path forward" on the extraterritorial application of their respective derivatives regulations. We think it reflects positive collaboration, and we continue to review and develop our views on its substance.

Conclusion

On behalf of MFA, I appreciate the Committee's focus on reauthorization of the CFTC. As discussed, we believe the Congress should adopt some refinements to the CEA in reauthorizing the CFTC. These amendments should take the form of amending the Bankruptcy Code to protect customer collateral, improvements to and streamlining of CPO and CTA oversight, and stronger protections for confidential information. In addition, we respectfully request that the Committee, in its oversight role of the CFTC, encourage data-driven regulations concerning position limits and greater international cooperation and coordination.

MFA is committed to working with Members and staff of the Committee and regulators to enhance our regulatory system and strengthen our nation's economy. Thank you for the opportunity to appear before you today. I would be happy to answer any questions that you may have.

WRITTEN TESTIMONY
OF
TERRENCE A. DUFFY
EXECUTIVE CHAIRMAN & PRESIDENT
CME GROUP INC.
BEFORE THE
SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION
July 17, 2013

Good afternoon Chairwoman Stabenow, Ranking Member Cochran, and Members of the Committee. Thank you for the opportunity to testify today regarding the CFTC's reauthorization. I am Terry Duffy, Executive Chairman and President of CME Group[1,2]

As the Committee considers reauthorization of the Agency, implementation of the Dodd-Frank Act continues to be central to the Committee's oversight. Dodd-Frank authorized the CFTC to create a regulatory structure for what had been unregulated swaps. Congress' goals were laudable: to reduce systemic risk through central clearing, to increase transparency and price discovery through exchange trading, to give government officials a window into swap dealings through transaction reporting, and to prevent fraud and market manipulation. Congress gave the CFTC a daunting task to write the regulations implementing this complex and far-reaching mandate, and the agency and staff are to be commended for their efforts to fix the swap market. Yet, despite these diligent efforts to establish swap regulations, the Commission often went far beyond Congress' intent, and in some instances adopted rules without providing needed guidance and clarification, relying upon last-minute no-action or exemptive relief to respond to confusion in the marketplace. Our industry would have ground to a standstill without last minute relief.

For example, the CFTC finalized its product definition rulemaking in the summer of 2012, with an effective date of October 12, 2012. This effective date triggered compliance obligations

---

[1] CME Group Inc. is the holding company for four exchanges, CME, the Board of Trade of the City of Chicago Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges"). The CME Group Exchanges offer a wide range of benchmark products across all major asset classes, including derivatives based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. The CME Group Exchanges serve the hedging, risk management, and trading needs of our global customer base by facilitating transactions through the CME Group Globex electronic trading platform, our open outcry trading facilities in New York and Chicago, and through privately negotiated transactions subject to exchange rules.

[2] My testimony supplements CME Group's letter dated May 1, 2013 to the Committee regarding CFTC's reauthorization.

relating to products defined as "swaps" under many different rulemakings previously finalized by the CFTC. However, market participants were confused about their responsibilities under these rulemakings because the CFTC had not yet completed critical rulemakings that would clarify whether certain types of contracts used in the energy markets were "swaps." Ultimately, and at the last minute before the compliance deadline, the CFTC issued an order delaying the implementation of these compliance obligations to allow the swaps and futures markets to continue operating without disruption until year end.

A few months later, lack of clarity in swap reporting rulemaking again led to confusion in the energy markets. When the swap data reporting obligations became effective, it was not clear to market participants whether they were required to provide historical trade data relating to certain energy contracts that have been listed and regulated as futures for over a decade. Notwithstanding the fact that this same trade data was already being reported to the CFTC under the existing futures rules, it was not clear, and remains unclear, whether this data was also subject to swap data reporting requirements. CME Group has submitted to the CFTC two requests for guidance, consistent with the CFTC's explicit indication in their proposed rulemaking that they would provide such guidance.[3] To date, energy market participants still have not received clarity from the CFTC regarding their recordkeeping or reporting obligations under the new swap rules, many of which are today in effect.

Furthermore, the Commission has used its swap mandate as a pretext to impose needless rules on the robustly regulated futures markets. Congress did not intend in Dodd-Frank to rewrite rules for this well-functioning, highly regulated marketplace, or to discourage market participants around the world from using U.S. markets. As the CFTC completes its remaining work to implement Dodd-Frank, we encourage the Committee to ensure that these rules remain within the Congressional mandate and do not undermine the ability of businesses in the U.S. and worldwide to continue to manage risk.

Margin Rules and Misplaced claims about "Futurization"

Futures markets have a long history of strong oversight and regulation. That history rebuts those that claim the "Futurization" of swap markets is a way to secure weaker regulation and more favorable margin treatment. Market participants trade futures because they understand the well-established rules for futures. Dodd-Frank makes clear that futures and swaps are different product classes and should receive similar, but not identical, regulation.

For example, margin is one of the areas of greatest concern to those decrying "Futurization." Margin requirements permit the clearing house that is clearing a contract to mitigate the risk attendant to that specific contract. CFTC rules set a floor for the amount of initial margin that clearinghouses must collect. At the CME's clearing house, margin is determined by risk management policies and procedures designed to account for the actual risk profile of the

[3] In the rule proposal relating to historical data reporting requirements, the Commission stated that it "expects to provide interpretive guidance concerning the determination of the reporting counterparty in situations where a historical swap was executed and submitted for clearing via a platform on which the counterparties to the swap do not know each other's identity." 77 Fed. Reg. 35200, 35211, n.43 (June 12, 2012).

product -- its underlying volatility and liquidation risk -- not its label as a swap or a future. In fact, many of our futures products require initial margin based on a two-day volatility measure, in excess of the CFTC's regulatory minimum for futures.

The example provided by the Lehman bankruptcy is informative. From the time CME decided to liquidate Lehman's house accounts' futures positions cleared by CME to the time of complete liquidation, six hours elapsed. This was a complex portfolio, across all of CME major product categories, with the margin required on the portfolio approaching $2 billion. We used a variety of market participants to liquidate, and did so with without needing to access assets beyond the margin that was appropriately posted according to CME's rules. Based on the Lehman experience, we can expect it will require more resources and industry coordination to liquidate complex swaps portfolios.

This example illustrates that whether a swap and a future share an economic profile is not the determinative factor to a clearing house in setting margins. The determinative factor is the overall risk profile of the product. And the liquidity and transparency afforded by that product's market infrastructure is a critical element of the product's risk profile.

It is consistent with the risk mitigation objectives of Dodd-Frank to ensure that margin requirements be tailored to address the risk characteristics of different contracts. Market participants will continue to use both customizable swaps and standardized futures products. Innovation, competition and customer choice among well-regulated markets for swaps and futures is not only a positive development for customers and the public as a whole, but is entirely consistent with the goals of Dodd-Frank. Congress should welcome this as an accomplishment of the Act.

Cross-Border Interpretative Guidance

The Agency's initial proposal to impose its rules across international borders without regard to local rules or regulators had threatened to expose the industry to conflicting duties and set the stage for retaliation from foreign regulators. We welcome the recent agreement between the CFTC and European Commission on a "Common Path Forward." We are hopeful that this positive development will lead to the US and EU regulators achieving workable mutual recognition of derivatives trading and clearing regulation.

In this regard, the joint statement of the CFTC and the European Commission noted the difference in treatment between the EU and US of initial margin coverage. While the minimum standards, such as initial margin, that apply to CCPs in the US and the EU may differ, they are both narrowly tailored to the relevant marketplaces in those jurisdictions, and accordingly, we would suggest, achieve the same risk mitigation outcome. Initial margin is just one of many risk mitigation techniques employed by CCPs (e.g. concentration charges, variation margin/mark to market). Due to CME's twice daily mark-to-market rules, CME's minimum margin period of risk of one day effectively covers twice the potential exposure of a portfolio in a given day. This approach to initial margin levels has been validated repeatedly during periods of market stress, including during the liquidation of house and customer portfolios where necessary. ESMA (the European Securities and Markets Authority) has imposed a 2-day minimum initial margin coverage. We believe that the application of a 2-day minimum for the US futures markets is both inappropriate based on market characteristics and unnecessarily costly to end users, including small agricultural producers who use the markets as a necessary hedge to their business risks.

Position Limits

The CFTC's over-reaching has extended to its physical commodity position limit rule. We have imposed position limits in the spot months for many of our own markets and an early warning system of accountability levels for all other trading months. The CFTC, however, tried to impose hard cap limits for all months, including the non-spot months, based on its view that in Dodd-Frank Congress had mandated those limits even if they were not found to be necessary.

Last year, a U.S. District Court Judge found the CFTC improperly concluded that it had a mandate post-Dodd-Frank to impose limits under any circumstances. The CFTC is appealing that decision. CME recently joined other market participants asking the court to direct the CFTC to determine that position limits are necessary and appropriate before imposing them.

Simultaneously with the appeal, the CFTC is also re-writing its position limits rule. To ensure that the CFTC relies upon accurate and current market data in its analysis, CME recently submitted updated deliverable supply data for physical commodities – energies, metals and agriculture products. The Commission should rely on these updated data if it undertakes to propose a new position limit rule.

Customer Protection

Industry Safeguards

I have previously testified about the rules CME Group, together with the National Futures Association ("NFA") and other U.S. futures exchanges have implemented to strengthen the protection of customer property (and its investment) at Futures Commission Merchants ("FCMs") through strict and regular reporting and daily feeds of cash and securities balances of all customer accounts at banks. They improve our work to mitigate the risk of, and early detection of, the improper transfer of customer funds and the improper reporting of customer asset balances, and improve our ability to check compliance with CFTC requirements for the investment of customer funds. Our efforts to enhance our monitoring continue today through the use of an account balance aggregation tool. Timely, including daily, access to this additional information is enabling us to better direct our regulatory resources at risk-based reviews of customer balances at clearing members and FCMs and their activity with respect to those balances.

Moreover, the CFTC has recently proposed additional rules on customer protection that include provisions codifying these initiatives, which we strongly support. However, this rulemaking also seeks to fundamentally change the way in which the futures marketplace operates. If a proposed "protective" measure is so expensive or its impact on market structure is so severe that customers cannot effectively use futures markets to mitigate risk or discover prices, the reason to implement that measure needs to be re-examined. Among the proposed rules to reevaluate is the rule that would require *at all times* an FCM's residual interest (its own funds) in segregated accounts to exceed the margin deficiencies of its customers. It does not appear that any system currently exists or could be constructed in the near future that will permit FCMs to accurately calculate customer margin deficiencies, continuously in real-time. Without access to this data, FCMs will be required to maintain substantial residual interest in segregated accounts or require customers to significantly over-collateralize their accounts. We believe this will be a significant and unnecessary drain on liquidity that will make trading significantly more expensive for customers to hedge. We believe this rule and others could have a very significant impact on certain sectors in the marketplace, particularly smaller FCMs that serve the agricultural community. The industry is conducting an impact analysis of these rules. We have urged the CFTC to allow the industry to complete this impact analysis before proceeding further with the rulemaking process.

Further, CME Group believes that proposed changes to Rule 1.52 threaten the viability of the current regulatory structure. This rule governs the manner in which self-regulatory organizations ("SROs"), such as CME and NFA, conduct their risk-based reviews of FCMs. Among other things, the proposed rule improperly conflates the roles played by an FCM's outside auditor and its regulatory examiners (designated SROs or DSROs), in essence requiring SROs and DSROs to replicate the role of an external auditor. SROs and DSROs are not staffed to play such a role, nor should they be. One of the primary strengths of the current regulatory scheme is that SROs and DSROs play a role distinct from, yet complementary to, that played by an outside auditor. Rather than simply replicating the work performed by outside auditors, the SROs and DSROs perform limited reviews that focus on particular areas of regulatory concern, including the segregation of customer funds and net capital requirements. This proposal would serve little regulatory purpose while imposing significant costs.

SRO Structure is Critical to Continued Customer Protection

Some critics suggest that self-regulation is a contributing factor to any failure or fraud in the financial services business. The self-regulation that is being criticized no longer exists. Yes, before exchanges demutualized and became public companies they were owned by their members and were responsible for regulating and disciplining their owners. That was self-regulation. Self-regulation in the context of modern futures markets regulation, though, is a misnomer.

The regulatory structure of the modern U.S. futures industry involves a comprehensive network of regulatory organizations that work together to ensure the effective regulation of all industry participants. The Commodity Exchange Act establishes the federal statutory framework that regulates the trading and clearing of futures and futures options in the United States, as well as swaps other than security-based swaps (which fall under the regulatory purview of the Securities Exchange Commission), pursuant to Dodd-Frank. The CEA is administered by the CFTC, which establishes regulations governing the conduct and responsibilities of market participants, exchanges and clearing houses. Thus, the industry's SRO-based regulatory structure is not that of a single entity governed by its members regulating its members, but rather a structure in which exchanges, most of which are public companies, regulate the activity of all participants in their markets - members as well as non-members - complemented with corollary oversight by the NFA and CFTC.

In the wake of certain high profile failures at FCMs, some have suggested that the SRO model should be discarded. This is a misguided suggestion that ignores the clear and significant benefits of the SRO model. Direct regulation by the exchange offers our regulators unique proximity to the markets, market participants and the broader resources of the exchange in ways that foster the development of expertise that not only helps to make our regulatory staff more effective, but also assists federal regulators in our common objective of preserving the integrity of the markets. Exchange sponsored regulation also allows for more expedient identification of potential issues given our knowledge of and proximity to the markets, as well as the ability to react more quickly and flexibly to potential market and regulatory issues. Finally, it should not be forgotten that SROs have very compelling incentives to ensure that the regulatory programs operate effectively, and devote considerable resources to regulating FCMs. CME, for example, spends more than $40 million each year on its regulatory function, and employs more than 200 financial and regulatory surveillance professionals, market regulation professionals and regulatory IT professionals.

The lesson from the failure of certain FCMs is not to tear down the SRO regulatory structure, but rather to build it even stronger to ensure direct and robust regulation by SROs. To that end, our focus has been, as it should be, on how our systems and processes can continue to evolve and improve so that we can best perform our role as an SRO. Over the last 18 months, the futures SRO model has been buttressed by new requirements the industry has put in place to deter another firm from misusing customer funds:

- Increased surprise reviews of customer segregated funds
- Daily segregation reporting by all FCMs
- Bi-monthly reporting on investment of segregated funds
- Periodic electronic confirmation of customer segregation balances from firms via e-confirm system
- New rules providing for daily feeds of cash and securities balances for all customer accounts at banks
- CEO/CFO signoffs of customer segregated fund distributions (Corzine rule)

These new rules, which, as noted above, have also been proposed by the CFTC in regulations to enhance protections afforded customers and customer funds, have strengthened SRO regulatory protection for all participants in the derivatives markets.

Bankruptcy Code Improvements

We believe that Congress could further enhance customer protections through amendments to the Bankruptcy Code. Potential amendments range from fundamental changes that would facilitate individual segregation of customer property, as an option should an FCM choose to offer it, to narrower revisions that would enhance a clearing house's ability to promptly transfer positions of non-defaulting customers. While amending the Bankruptcy Code is a significant undertaking, CME Group believes in light of recent experience that modification to the bankruptcy regime would benefit customers and the market as a whole.

Insurance for Future Study

In the wake of MF Global and Peregrine Financial, some have advocated establishing an insurance scheme to protect futures customers. Any such proposal must be analyzed in light of the costs and potentially limited efficacy of such an approach due the extraordinarily large amount of funds held in U.S. segregation.

The futures industry, led by the Futures Industry Association[4], is researching various insurance mechanisms in order to provide a quantitative, data-based analysis that will enable policymakers and market participants to determine whether insurance for futures would be viable.

Agency Funding and Proposals to Merge the CFTC and SEC

Finally, I want to briefly address the issues of agency funding and proposals to merge the CFTC and SEC.

It is essential to customer protection and healthy U.S. derivatives markets that the agency that oversees us be adequately funded. But we strongly oppose the Administration's proposal to fund the entire amount with a "user fee,'' which is just another name for a transaction tax. The Administration's FY-2014 Budget proposes to increase the CFTC's budget by $109 million to $315 million and to fund the entire amount with a "user fee" levied on futures and derivatives trades. Such a "user fee" will impose a $315 million per year transaction tax on market making, which is an essential source of market liquidity. Imposing this new tax would also increase the cost of business for all customers, even those the Administration wants to exempt, because it would reduce liquidity, increase volatility, and impair the efficient use of U.S. futures markets. It will make it more difficult and expensive for farmers, ranchers, and other end users to hedge commodity price risk in the market. This will force farmers and other market participants to pass along these higher costs to consumers in the form of higher food prices.

Moreover, the tax will change the competitive balance in favor of foreign and OTC markets with lower transaction costs where, in an electronic trading environment, market users can and will shift their business; lessen the value of the information provided to farmers and the financial services industry by means of the price discovery that takes place in liquid, transparent futures markets with low transaction costs; increase the cost to the government resulting from less liquid government securities markets; and fail to actually collect the funds anticipated when volume drops and market participants choose lower cost alternative jurisdictions and markets. Last week, regulators in India saw derivatives volume drop by more than a third immediately following implementation of a one percent transaction tax.

For all of these reasons, Congress should reject a transaction tax to fund the CFTC.

---

[4] CME Group, the Institute for Financial Markets ("IFM") and the NFA are also sponsors of the study.

With respect to proposals to merge the CFTC and SEC, we continue to believe that such a merger is unwarranted and would hamper, rather than increase, the effectiveness of each of these critical agencies. Derivatives and equities markets differ greatly in market structure, market purpose, and regulatory structure. Equities markets are fragmented, with multiple pools of liquidity both on and off exchange. The purposes of equities markets include investment and capital formation, while those of derivatives markets are primarily to hedge risk and discover macro-economic prices. And while the regulation of equities markets has traditionally been through a strict rules-based regime, the Commodity Exchange Act, which governs derivatives markets, has a principles-based structure.

While there are instances in which the two agencies must and should coordinate on rulemakings for these differing markets, this does not support the wholesale elimination of the regulatory structures that have evolved to address the unique needs and purposes of these markets, and we urge the Committee to oppose efforts to do so. Derivatives markets are critical to the systemic integrity of financial markets in the U.S. and around the world. Both derivatives and equities markets play a vital role in the domestic and international economy. Each should have its own regulator and regulatory structure that focuses on the unique challenges of each marketplace.

Conclusion

These are just a few of the many issues that have been submitted to the Committee in connection with your consideration of CFTC reauthorization. We stand ready to be a resource to the Committee on these and other critical issues to the futures and derivatives marketplace.

Testimony of
Mr. Gene Guilford
Commodity Market Oversight Coalition

Before the
United States Senate
Committee on Agriculture, Nutrition and Forestry
Washington, DC
July 17, 2013

Honorable Chairwoman Stabenow, Ranking Member Cochran and distinguished members of the committee, on behalf of the Commodity Market Oversight Coalition [CMOC] we wish to thank you for the opportunity to appear before you today on the matter of the reauthorization of the Commodity Futures Trading Commission [CFTC] and to address matters relating to the CFTC's authorities regulating the activities in the commodity markets.

About CMOC

The Commodity Markets Oversight Coalition (CMOC) is a non-partisan alliance of organizations that represent commodity-dependent American industries, businesses, end-users and consumers. We are the farmers, truckers, heating oil retailers, mom and pop gasoline station operators, airlines and others who rely on transparent, functional and stable commodity markets in which to hedge our operations for the mutual benefit of those who deliver tangible goods to markets and from which we take delivery of tangible goods, as well as for the benefit of the millions of consumers we serve. 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.

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.

Why is an active, adequately funded and fully authorized CFTC necessary?

The CFTC was last reauthorized through 2013 in the Food, Conservation and Energy Act of 2008, also known as the "2008 Farm Bill". 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. [1]/ 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,

[1] 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.

[2]/ 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.

Even with its imperfections, one cannot say that Dodd-Frank was unnecessary or that the new authorities granted to the CFTC under the Act were inappropriate.

In the mid-1990s the over-the-counter derivatives market had a notional value of between $20-$25 trillion. Today the derivatives market's notional value exceeds $600 trillion. Even then, there had been episodes of fraud. Bankers Trust was a large over-the-counter derivatives dealer, and it became clear, through suits brought by some of its customers—primarily Procter & Gamble and Gibson Greeting Cards—that Bankers Trust had defrauded some of its derivatives customers. Second, there was evidence of manipulation in the markets. Sumitomo Corporation had managed to manipulate the world market in copper, in part using over-the-counter derivatives to disguise its operations and fund them. Later, and after the fact, there were other incidents of market manipulation discovered involving Enron and electricity markets, Amaranth and natural gas markets [3]/, BP/Propane and the propane markets [4]/, as well as crude oil [5]/

We can never forget that concerns were raised about these unregulated, rapidly growing markets that were characterized by a lack of transparency, unlimited leverage, and interconnections between large institutions through counterparty credit risk. Those features of the market appeared to create the potential of systemic risk, as was later confirmed in the financial crisis of 2008.

---

[2] Pub.L.111-203

[3] http://www.hsgac.senate.gov//imo/media/doc/REPORTExcessiveSpeculationintheNaturalGasMarket.pdf?attempt=2

[4] http://www.cftc.gov/PressRoom/PressReleases/pr5405-07

[5] http://www.crai.com/uploadedFiles/Publications/FM-Insights-Commodity-Price-Manipulation.pdf

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, 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.

The financial crisis that began with the fall of Lehman and a cascade of other powerful financial institutions, leading ultimately to the loss of more than $12 trillion of national wealth, the loss of millions of American jobs, the loss of value of millions of American homes, 401-k plans and pensions is why we need the Commodity Futures Trading Commission. The nation needs commodity markets that are free of manipulation, free of excessive speculation, fully transparent, with participants accountable for their behavior and activities and properly overseen for the benefit and protection of consumers and taxpayers. Hopefully, we have not forgotten what the absence of effective oversight and regulation has wrought upon the nation as we continue to struggle to recover from the greatest threat to the nation's economy since the Great Depression.

When accepting the John F. Kennedy Profiles in Courage Award in 2009, former CFTC Chair Brooksley Born stated, ***"Special interests in the financial services industry are beginning to advocate a return to 'business as usual' and to argue against the need for any serious reform. We have to muster the political will to overcome these special interests. If we fail now to take the remedial steps to close the regulatory gap, we will be haunted by our failure for years to come."***

Manipulation and 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, as well as the underlying statutory authorities of the CFTC, in preventing market manipulation and the harmful effects of excessive speculation.** [6]/ 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).

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

[6] 7 U.S.C Section 6(a)(1)

the balance between commercial hedgers and financial investors is to require aggregate limits on all speculation as a class 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. [7]/ We attach as Appendix "A" the list of more than 100 independent studies that point to the role excessive speculation plays in the artificial inflation of commodity prices that is the focus of the position limits rule.**

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.* [8]/

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

[7] 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.

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

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, then 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 Congress has to look no further than the way Wall Street markets participation in index funds for the reason why and how index funds adversely affect the orderly operation of these markets and artificially inflate commodity prices, as follows;

> ***"How do I sell something that I don't own, or why would I buy something I don't need".*** The answer is simple. When trading futures, you never actually buy or sell anything tangible; you are just contracting to do so at a future date. You are merely taking a buying or selling position as a speculator, expecting to profit from rising or falling prices. You have no intention of making or taking delivery of the commodity you are trading, your only goal is to buy low and sell high, or vice-versa. Before the contract expires you will need to relieve your contractual obligation to take or make delivery by **offsetting** (also known as unwind, or liquidate) your initial position. Therefore, if you originally entered a short

position, to exit you would buy, and if you had originally entered a long position, to exit you would sell." [9]/

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.

In response to the 2010 "flash crash," on November 2, 2011, Sen. Tom Harkin (D-IA) and Rep. Peter DeFazio (D-OR) introduced the Wall Street Trading and Speculators Tax Act, which would impose a .03 percent excise tax on all trades of securities. Sen. Harkin and Rep. DeFazio said an analysis by the Joint Committee on Taxation estimated the tax would generate $352 billion in revenue from January 2013 through 2021, if enacted. The tax was designed to disproportionately affect HFTs, who place thousands of trades in a matter of minutes. While this effort failed in 2011, on February 28, 2013, Sen. Harkin and Rep. DeFazio reintroduced a financial transaction tax bill, which was then referred again to the House Ways and Means and Senate Finance committees. CMOC looks forward to working with the Congress as it considers these important measures.

[9] http://www.altavest.com/education/default.aspx

More recently, some have accused algo-trading as responsible for a 145-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 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. [10]/ 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. [11]/ 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. [12]/

As a corollary to these concerns is the practice of market information gathering organizations to release data to certain paying customers minutes prior to the same information being release to the general public. A June 12, 2013 CNBC report cites that "contract signed by Thomson Reuters, the news agency and data provider, and the University of Michigan, which produces the widely cited economic statistic, stipulates that the data will be posted on the web for the general public at 10 a.m. on the days it is

[10] "High-speed Traders Exploit Loophole," *The Wall Street Journal,* May 1, 2003. Link: http://on.wsj.com/15a3uVS (Accessed May 1, 2013)

[11] "Statement of Chairman Gary Gensler before the CFTC Technology Advisory Committee," April 30, 2013.

[12] "Europe to ban high-frequency trading in commodities," BullionStreet (blog), October 29, 2012. Link: http://bit.ly/15a3mG7 (Accessed May 1, 2013)

released. Five minutes before that, at 9:55 a.m., the data is distributed on a conference call for Thomson Reuters' paying clients, who are given certain headline numbers. But the contract carves out an even more elite group of clients, who subscribe to the "ultra-low latency distribution platform," or high-speed data feed, offered by Thomson Reuters. Those most elite clients receive the information in a specialized format tailor-made for computer-driven algorithmic trading at 9:54:58.000, according to the terms of the contract. On occasion, they could get the data even earlier—the contract allows for a plus or minus 500 milliseconds margin of error.

"In the ultra-fast world of high-speed computerized markets, 500 milliseconds is more than enough time to execute trades in stocks and futures that would be affected by the soon-to-be-public news. Two seconds, the amount promised to "low latency" customers, is an eternity.

For exclusive access to the data, Thomson Reuters pays the University of Michigan $1 million per year, according to the contract, in addition to a "contingent fee" based on the revenue generated by Thomson Reuters. The contract reviewed by CNBC was signed in September 2009. It expired a year later. Thomson Reuters and the University Michigan confirmed that the relationship still exists." [13]/

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. We attached as Appendix "B" the listing of independent studies showing the harmful effects of high speed trading on the orderly operation of commodity markets.

---

[13] June 12, 2013 http://www.cnbc.com/id/100809395

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. [14]/ 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 institutions 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. [15]/ 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.

---

[14] 7 U.S.C. §13
[15] Pub.L.91-598

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 such a widespread and vital component of the American economy as it is today. As a result, when the brokerage firm MF Global filed for bankruptcy over 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.

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. 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. 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 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." 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. 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.**

CFTC Resources

In retrospect, not to criticize but to make an observation with the benefit of hindsight, in establishing deadlines for the completion of regulatory proceedings within 365 days of the enactment of Dodd-Frank was an error. The hundreds of complex issues that needed to be addressed, most with the coordination of other agencies, was a recipe for putting the CFTC severely behind in meeting their statutory deadlines.

Today CFTC staff is at 689 people, only 9 percent bigger than 20 years ago. At minimum CFTC needs 1,015 people in addition to new technology investments. CFTC collected 2 billion in fines last year (benefitting the Treasury, not CFTC budget) – that is CFTC appropriations funding for 22 prior fiscal years. This year the size of the CFTC actually contracted because of sequestration and cut 20-30 people from the staff. The CFTC hasn't been able to hire experts on swaps markets, which is needed. The CFTC needs new technology in order to even try to keep up with the $600 trillion derivatives market and the private sector technology advancements that the agency is responsible for overseeing. If flat funding is provided, CFTC would have to cut another 50 people (about 8 or 9 percent) despite the responsibility to cover the swaps market. Therefore, we continue to urge Congress to fully fund the CFTC at the levels requested by the administration.

CONCLUSION

In this reauthorization effort we need to not only examine the necessary corrections for the imperfections in Dodd-Frank that we have cited, but also the magnitude of the new authorities the CFTC was given to protect the sanctity of the commodity markets and the pocketbooks of American taxpayers and the diminished resources with which this agency has had to operate under extraordinarily difficult circumstances.

Thank you for the opportunity to appear with you today and I would be happy to answer any questions you may have.

Appendix A

Independent Studies on the Negative Effects of Commodity Speculation

Evidence on the Negative Impact of Commodity Speculation by Academics, Analysts and Public Institutions

21 May 2013

Note: This list is constantly being updated and revised. It only collects evidence that supports a critical view of commodity speculation in general or certain elements of it.

Compiled by Markus Henn, WEED, markus.henn@weed-online.org, www.weed-online.org

A) Academic peer reviewed journal articles

1) Baffes, John (The World Bank) (2011): The long-term implications of the 2007–08 commodity-price boom. Development in Practice, Vol. 21, Issue 4-5, pages 517-525: „Demand by emerging economies is unlikely to put additional pressure on the prices of food commodities, although it may create such pressure indirectly through energy prices. The effect of biofuels on food prices has not been as great as originally thought, but the use of commodities by investment funds may have been partly responsible for the 2007–08 spike."

2) Belke, Ansgar (IZA/University Duisburg-Essen) / Bordon, Ingo G. (University Duisburg-Essen) / Volz, Ulrich (German Development Insitute) (2012): Effects of Global Liquidity on Commodity and Food Prices. World Development, in press: "Over the period that we observed, 1980–2011, food and commodity price inflation were apparently driven by monetary expansion in the world's major economies. By examining the pertinence of monetary liquidity, our results add to the discussion on a financialization of commodities, that stresses the aspect of financial liquidity, where food and commodity prices are driven to a large extent by flows of portfolio investment seeking return in commodity markets and not merely by demand from the real economy. Policymakers should care about the negative side-effects of loose monetary policy and consider stricter regulation of food and commodity markets – such asthe imposition of tighter limits on speculative positions in food commodities – to prevent a further flow of liquidity into these markets."

3) Chevallier, Julien (University of Paris) (2012): Price relationships in crude oil futures: new evidence from CFTC disaggregated data. Environmental Economics and Policy Studies, August 2012: „we are able to highlight the influence of the CFTC "Money Managers" net position category (as a proxy of speculative trading) on the oil price at reasonable statistical confidence levels. (...) The policies being considered by the CFTC to put aggregate position limits on futures contracts and to increase the transparency of futures markets are moves in the right direction."

4) Cifarelli, Giulio (University of Florenz) / Paladino, Giovanna (LUISS University / BIS) (2010): Oil price dynamics and speculation: A multivariate financial approach. Energy Economics, Vol. 32, Issue 2, March 2010, pages 363–372: "Despite the difficulties, we identify a significant role played by speculation in the oil market, which is consistent with the observed large daily upward and downward shifts in prices — a clear evidence that it is not a fundamental-driven market."

5) Czudaj, Robert / Beckmann, Joscha (Duisburg University) (2012): Spot and futures commodity markets and the unbiasedness hypothesis - evidence from a novel panel unit root test. Economics Bulletin, 2012, vol. 32, issue 2, pages 1695-1707: "Our findings show that most spot and futures markets for commodities were efficient until the turn of the millennium, but appear to be inefficient thereafter owing to an increase in volatility, which might be attributed to the intense engagement of speculation in commodity markets."

6) Du, Xiaodong / Yu, Cindy L. / Hayes, Dermott J. (Iowa State University) (2011): Speculation and Volatility Spillover in the Crude Oil and Agricultural Commodity Markets : A Bayesian Analysis. Energy Economics, Vol. 33, Issue 3, May 2011, pages 497–503: "Speculation, scalping, and petroleum inventories are found to be important in explaining oil price variation."

7) Fan, Ying (Chinese Academy of Sciences) / Xu, Jin-Hua (Hefei University) (2011): What has driven oil prices since 2000? A structural change perspective: "Through establishing a comparative model, we quantitatively measure the effects of speculation and episodic events such as wars on oil price changes. We find that the explanatory power of the models is obviously improved after allowing for the two factors. In particular, during the "Relatively calm market" period (January, 2000 to March, 2004) and "Bubble accumulation" period (March, 2004, to June, 2008), when the speculation variables are considered, not only they are significant, but also the explanatory ability greatly rises and various diagnostic tests are improved, indicating that speculation is a highly influential factor on oil price changes in these periods."

8) Gilbert, Christopher (Trento University) (2010): How to understand high food prices. Journal of Agricultural Economics, Vol. 61, Issue 2, pages 398–425: "By investing across the entire range of commodity futures, index-based investors appear to have inflated food commodity prices."

9) Gutierrez, Luciano (University of Sassari) (2012): Speculative bubbles in agricultural commodity markets. European Review of Agricultural Economics, 2012, pages 1-22: "We investigate whether commodity prices during the spike of 2007–2008 might have deviated from their intrinsic values based on market fundamentals. To do this, we use a bootstrap methodology to compute the finite sample distributions of recently proposed tests. Monte-Carlo simulations show that the bootstrap methodology works well, and allows us to identify explosive processes and collapsing bubbles for wheat, corn and rough rice. There was less evidence of exuberance in soya bean prices."

10) Hache, Emmanuel / Lantz, Fréderic (IFP Énergies Nouvelles, Paris) (2012): Speculative Trading & Oil Price Dynamic: A study of the WTI market. Energy Economics (Accepted Manuscript, 3 September 2012): "We conclude that the hypothesis of an influence of noncommercial players on the probability for being in the crisis state cannot be rejected. In addition, we show that the rise in liquidity of the first financial contracts, as measured by the volume of open interest, is a key element to understand the dynamics in market prices."

11) Kaufmann, Robert K. / Ullman, Ben (Boston University) (2009): Oil prices, speculation, and fundamentals: Interpreting causal relations among spot and futures prices:

"Together, these results suggest that market fundamentals initiated a long-term increase in oil prices that was exacerbated by speculators, who recognized an increase in the probability that oil prices would rise over time."

12) Kaufmann, Robert K. (Boston University) (2011): The role of market fundamentals and speculation in recent price changes for crude oil. Energy Policy, Volume 39, Issue 1, January 2011, Pages 105-115: „Although difficult to measure directly, I argue for the role of speculation based on the following: (1) a significant increase in private US crude oil inventories since 2004; (2) repeated and extended break-downs (starting in 2004) in the cointegrating relationship between spot and far month future prices that are inconsistent with the law of one price and arbitrage opportunities; and (3) statistical and predictive failures by an econometric model of oil prices that is based on market fundamentals. These changes are related to the behavior and impact of noise traders on asset prices to sketch mechanisms by which speculative expectations can effect crude oil prices."

13) Mayer, Jörg (UNCTAD) (2012): The Growing Financialisation of Commodity Markets: Divergences between Index Investors and Money Managers. Journal of Development Studies, Vol. 48, Issue 6, pages 751-767: "During 2006–2009, index trader positions had a price impact for some agricultural commodities, as well as oil. During 2007–2008, money managers impacted prices for non-agricultural commodities, especially copper and oil."

14) Newman, Susan A. (University of the Witwatersand) (2009): Financialization and Changes in the Social Relations along Commodity Chains: The Case of Coffee. Review of Radical Political Economics, Vol. 41, No. 4, pages 539-559: "It is argued that increased financial investment on international commodity exchanges, together with market liberalization, have given rise to opportunities and challenges for actors in the coffee industry. Given the heterogeneity of market actors, these tend to exacerbate inequalities already present in the structure of production and marketing of coffee."

15) Nissanke, Machiko (University of London) (2012): Commodity Market Linkages in the Global Financial Crisis: Excess Volatility and Development Impacts. Journal of Development Studies, Vol. 48, Issue 6, pages 732-750: "This article (...) suggests that a significant portion of the closely synchronised price dynamics in commodity and financial markets is explained by market liquidity cycles in global finance, as financial investors manage their portfolio at ease through 'virtual' stock holdings of commodities in derivatives dealings and markets."

16) Morana, Claudio (University of Milano, Bicocca) (2012): Oil price dynamics, macro-finance interactions and the role of financial speculation. Journal of Banking & Finance, in press: "While we then find support to the demand side view of real oil price determination, we however also find a much larger role for financial shocks than previously noted in the literature."

17) Sigl-Grüb, Christoph / Schiereck, Dirk (Technical University Darmstadt) (2010): Speculation and nonlinear price dynamics in commodity futures markets. Investment Management and Financial Innovations, Vol. 7, Issue 1, pages 59-73: "In this article we present theoretical considerations and empirical evidence that the short-run autoregressive behavior of commodity markets is not only driven by market fundamentals but also by the trading of speculators."

18) Silvennoinen Annastiina (Queensland University) / Thorp, Susan (Sydney University) (2013): Financialization, crisis and commodity correlation dynamics. Journal of International Financial Markets, Institutions and Money, Vol. 24, April 2013, Pages 42–65: „Stronger investor interest in commodities may create closer integration with conventional asset markets. We estimate sudden and gradual changes in correlation between stocks, bonds and commodity futures returns driven by observable financial variables and time (...). Most correlations begin the 1990s near zero but closer integration emerges around the early 2000s and reaches peaks during the recent crisis. (...) Increases in VIX and financial traders' short open interest raise futures returns volatility for many commodities. Higher VIX also increases commodity returns correlation with equity returns for about half the pairs, indicating closer integration."

19) Tang, Ke (Princeton University) / Xiong, Wei (Renmin University) (2012): Index Investment and the Financialization of Commodities. Financial Analyst Journal, Vol 68,Number 6, pages 54-74: "concurrent with the rapid growth of index investment in commodity markets, prices of non-energy commodities have become increasingly correlated with oil prices. This trend is significantly more pronounced for commodities in two popular indices: the S&P GSCI and the DJ-UBSCI. Our findings reflect a fundamental process of financialization among commodity markets, through which commodity prices have become more correlated with each other. As a result of the financialization process, the price of an individual commodity is no longer determined solely by its supply and demand. Instead, prices are also determined by tbe aggregate risk appetite for financial assets and the investment bebavior of diversified commodity index investors."

20) Tokis, Damir (ESC Rennes) (2011): Rational destabilizing speculation, positive feedback trading, and the oil bubble of 2008. Energy Economics, Vol. 39, Issue 4, April 2011, pages 2051–2061: „institutional investors that invest in crude oil to diversify their portfolios and/or hedge inflation can destabilize the interaction among commercial participants and liquidity-providing speculators."

B) Research papers published by universities and public institutions

1) Adämmer, Philipp / Bohl, Martin T. / Stephan, Patrick M. (University of Münster) (2011): Speculative Bubbles in Agricultural Prices: „The empirical evidence is favorable for speculative bubbles in the corn and wheat price over the last decade."

2) Algieri, Bernardina (Bonn University) (2012): Price Volatility, Speculation and Excessive Speculation in Commodity Markets: Sheep or Shepherd Behaviour?: „...this study shows that excessive speculation drives price volatility, and that often bilateral relationships exist between price volatility and speculation. (...) excessive speculation has driven price volatility for maize, rice, soybeans, and wheat in particular time frames, but the relationships are not always overlapping for all the considered commodities."

3) Algieri, Bernardina (Bonn University) (2013): A Roller Coaster Ride: an empirical investigation of the main drivvers of wheat price: "The variables with the largest effects on price movements over the period 1995-2012 are the global demand, speculation, and the real effective exchange rate. This testifies that the financial 25 and wheat markets have become more and more interwoven, and "speculation" based on investing in futures contract s on commodity markets, to profit from price fluctuations, is an important determinant of price dynamics."

4) Anderson, David et al. (Texas University) (2008): The effects of ethanol on Texas food and feed: "Speculative

fund activities in futures markets have led to more money in the markets and more volatility. Increased price volatility has encouraged wider trading limits. The end result has been the loss of the ability to use futures markets for price risk management due to the inability to finance margin requirements."

5) Baffes, John (The World Bank) / Haniotis, Tassos (European Commission) (2010): Placing the 2006/08 Commodities Boom into Perspective. World Bank Research Working Paper 5371: "We conjecture that index fund activity (one type of "speculative" activity among the many that the literature refers to) played a key role during the 2008 price spike. Biofuels played some role too, but much less than initially thought. And we find no evidence that alleged stronger demand by emerging economies had any effect on world prices."

6) Baldi, Lucia / Peri, Massimo, Vandone, Daniela (Universita degli Studi di Milano) (2011): Price discovery in agricultural commodities: the shifting relationship between spot and futures prices: "Last but not least, financial speculation, which caused considerable price volatility and prevented the planning of supply in many countries, contributed to creaing a situation of market instability."

7) Bass, Hans H. (University of Bremen) (2011): Finanzmärkte als Hungerverursacher? Studie für Welthungerhilfe e.V.: „Das Engagement der Kapitalanleger auf den Getreidemärkten führte nach unseren Berechnungen in den Jahren 2007 bis 2009 im Jahresdurchschnitt zu einem Spielraum für Preisniveauerhöhungen von bis zu 15 Prozent."

8) Basak, Suleyman / Pavlova, Anna (London Business School / Centre for Economic Policy Research) (2013): We find that in the presence of institutions the prices of all commodity futures go up. The price rise is higher for futures belonging to the index than for nonindex ones. If a commodity futures is included in the index, supply and demand shocks specific to that commodity spill over to all other commodity futures markets. In contrast, supply and demand shocks to a nonindex commodity affect just that commodity market alone. In the presence of institutions the volatilities of both index and nonindex futures go up, but those of index futures increase by more. Furthermore, financialization leads to an increase in the correlations amongst commodity futures as well as in equity-commodity correlations. Increases in the correlations between index commodities exceed those for nonindex ones. We model explicitly demand shocks which allows us to disentangle the effects of financialization from the effects of rising demand for commodities, and find that in the presence of demand shocks the impact of institutions on futures prices becomes considerably stronger."

9) Basu, Parantap / Gavin, William T. (Federal Reserve Bank of St. Loius) (2011): What explains the Growth in Commodity Derivatives?: "Banks argue that they need to use commodity derivatives to help customers manage risks. This may be true, but the recent experience in commodity futures did not reduce risks but exacerbated them just at the wrong time."

10) Bicchetti, David / Maystre, Nicolas (UNCTAD) (2012): The synchronized and long-lasting structural change on commodity markets: evidence from high frequency data: „we document a synchronized structural break, characterized by a departure from zero, which starts in the course of 2008 and continues thereafter. This is consistent with the idea that recent financial innovations on commodity futures exchanges, in particular the high frequency trading activities and algorithm strategies have an impact on these correlations."

11) Boos, Jaap W.B. (Universität Maastricht, School of Business and Economics) / van der Moolen, Maarten (Rabobank) (2012): A Bitter Brew? Futures Speculation and Commodity Prices: "speculation is an important part of the coffee price generation process."

12) Borin, Alessandro / Di Nino, Virginia (Bank of Italy) (2012): The role of financial investments in agricultural commodity derivatives markets: „this result gives some support to the idea that swap dealers, whose growing weight in the regulated exchanges tends to reflect the large exposures of "commodity index investors" in the OTC markets, may have a destabilizing impact on futures prices, at least in the short run. On the contrary, the activity of more traditional speculators seems to favour price stability, probably enhancing market liquidity."

13) Büyüksahin, Bahattin (International Energy Agency) / Robe, Michel A (American University) (2010): Speculators, Commodities and Cross-Market Linkages: "We then show that the correlations between the returns on investable commodity and equity indices increase amid greater participation by speculators generally and hedge funds especially."

14) Cheng, Ing-Haw (University of Michigan) / Kirilenko, Andrei (CFTC) / Xiong, Wei (Princeton University) (2012): Convective Risk Flows in Commodity Futures Markets: „We find that CITs and hedge fund positions reacted negatively to the VIX during the recent financial crisis... Consistent with theories suggesting this is related to the distress of financial institutions, we find that CITs with high CDS spreads are more sensitive to movements in the VIX. Contrary to the hedging pressure hypothesis, we do not find that hedgers increased their hedges as the VIX rose. Finally, the findings show that the reactions of all trader groups were persistent over time. This evidence suggests that during times of distress, there was a flow of risk away from financial institutions back towards commercial hedgers."

15) Coleman, Les / Dark, Jonathan (University of Melbourne) (2012): Economic Significance of Non-Hedger Investment in Commodity Markets: "We find a cointegrating relationship in larger markets between scaled open interest and real spot price, where it is usually the price that adjusts to deviations from long run equilibrium."

16) Cooke, Bryce / Robles, Miguel (IFPRI) (2009): Recent Food Prices Movements. A Time Series Analysis: "Overall, our empirical analysis mainly provides evidence that financial activity in futures markets and proxies for speculation can help explain the observed change in food prices; any other explanation is not well supported by our time series analysis."

17) Creti, Anna / Joëts, Marc / Mignon, Valérie (CEPII, Paris) (2012): On the links between stock and commodity markets' volatility: "Our results show that correlations between commodity and stock markets are time-varying and highly volatile. The impact of the 2007-2008 financial crisis is noticeable, emphasizing the links between commodity and stock markets, and highlighting the financialization of commodity markets. We also show that, while sharing some common features, commodities cannot be considered a homogeneous asset class: a speculation phenomenon is for instance highlighted for oil, coffee and cocoa, while the safe-haven role of gold is evidenced."

18) Dicembrino, Claudio / Scandizzo, Pasquale L. (University of Rome) (2012): The Fundamental and Speculative Components of the Oil Spot Price: "Our results show that speculative components, measured according to mathematical option theory, may be at the origin of significant and sizable effects on oil prices, specially for what concerns the episodes of extreme variations. The

speculation issue, however, suggests that further investigation may be conducted in order to identify the factors affecting the speculation itself."

19) Dorfman, Jeffrey H. / Karali, Berna (University of Georgia) (2012): Have Commodity Index Funds Increased Price linkages between Commodities?: "In combination with our results on correlation coefficients and non-stationarity, these empirical results are indicative, but not fully convincing, of the growth of commodity index funds impacting commodity futures market linkages over the last eight years."

20) Doroudian, Ali / Vercammen, James (University of British Columbia) (2012): First and Second Order Impacts of Speculation and Commodity Price Volatility: „Both of these results are consistent with the theoretical arguments that speculation which involves large-scale institutional investment can have first and second order impacts on commodity price volatility."

21) Eckaus, R.S. (MIT) (2008): The Oil Price Really Is A Speculative Bubble: "Since there is no reason based on current and expected supply and demand that justifies the current price of oil, what is left? The oil price is a speculative bubble."

22) Einloth, James T. (FDIC) (2009): Speculation and Recent Volatility in the Price of Oil: "The paper finds the evidence inconsistent with speculation having played a major role in the rise of price to $100 per barrel in March 2008. However, the evidence suggests that speculation did play a role in its subsequent rise to $140."

23) Frankel, Jeffrey (Harvard Kennedy School) / Rose, Andrew K. (Haas School of Business, UC Berkeley) (2010): Determinants of Agricultural and Mineral Commodity Prices: "Our annual empirical results show support for the influence of economic activity, inventories, uncertaintym the spread and recent spot price changes."

24) Gilbert, Christopher (Trento University) (2010): Speculative Influences on Commodity Futures Prices: "The results ... indicate that index-based investment in commodity futures may have been responsible for a significant and bubble-like increase of energy and non-ferrous metals prices, although the estimated impact on agricultural prices is smaller."

25) Gilbert, Christopher / Pfuderer, Simone (University of Trento) (2012): Index Funds Do Impact Agricultural Prices: „We use Granger-causality methods to re-examine the data analyzed in Sanders and Irwin (2011a). Our analysis supports their conclusion that mo impacts are discernible for the four grains markets they consider. However, Granger-causality is established in the less liquid soybean oil and livestock markets. We conjecture that index investment does also have price impact in liquid markets but that market efficiency prevents the detection of this impact using Granger-causality tests."

26) Girardi, Daniele (University of Siena) (2011): Do financial investors affect commodity prices? The case of Hard Red Winter Wheat: "Our empirical analysis suggests that financial investors played an important role in affecting wheat price fluctuations in recent years. In particular they seem to have linked wheat price dynamics to US equity market returns and to oil price movements."

27) Ghosh, Jayati (Jawaharlal Nehru University) (2010): Commodity speculation and the food crisis: "Thus international commodity markets increasingly began to develop many of the features of financial markets, in that they became prone to information asymmetries and associated tendencies to be led by a small number of large players. Far from being 'efficient markets' in the sense hoped for by mainstream theory, they allowed for inherently 'wrong' signalling devices to become very effective in determining and manipulating market behaviour. The result was the excessive price volatility that has been displayed by important commodities over the recent period – not only the food grains and crops mentioned here, but also minerals and oil."

28) Goyal, Ashima / Tripathi, Shruti (Indira Gandhi Institute of Development Research) (2012): Regulations and price discovery: oil spot and futures markets: „The results show expectations mediated through financial markets did not lead to persistent deviations from fundamentals. (...) But there is stronger evidence of short-term or collapsing bubbles in mature market futures compared to Indian, although mature markets have a higher share of hedging. Indian regulations such as position limits may have mitigated short duration bubbles. It follows leverage due to lax regulation may be responsible for excess volatility."

29) Greenberger, Michael (University of Maryland) (2010): The Relationship of Unregulated Excessive Speculation to Oil Market Price Volatility: "When speculators make up too large a share of the futures market, they have the potential to upset the healthy tension between consumers and producers and resulting adherence of prices to market fundamentals. The resulting volatility makes it more difficult for commercial consumers and producers to successfully hedge risk, because prices do not reflect market fundamentals, and so they abandon the futures market and risk shifting—thereby further destabilizing the price discovery influence of these markets."

30) Halova, Marketa W. (Washington State University) (2012): The Intraday Volatility-Volume Relationship in Oil and Gas Futures: "For the nearby contract, Granger-causality tests show that past values of volume help explain volatility which agrees with the Sequential Information Arrival Hypothesis. Past values of volatility have explanatory power for volume only when absolute return is used as the volatility measure; when the conditional variance from GARCH models is used as the volatility measure, the causality in this direction disappears. These results change when low-frequency daily data is applied. (...) if past volume can be used to forecast volatility, markets are not efficient. Therefore, the lagged volume having explanatory power for volatility indicates some market inefficiency, at least at the 10-minute interval frequency."

31) Hamilton, James (University of California) (2009): Causes and Consequences of the Oil Shock of 2007-08: „With hindsight, it is hard to deny that the price rose too high in July 2008, and that this miscalculation was influenced in part by the flow of investment dollars into commodity futures contracts."

32) Hamilton, James D. (University of California) / Wu, Cynthia (University of Chicago) (2011): Risk Premia in Crude Oil Futures Prices: "We document significant changes in oil futures risk premia since 2005, with the compensation to the long position smaller on average but more volatile in more recent data. This observation is consistent with the claim that index-fund investing has become more important relative to commercial hedging in determining the structure of crude oil futures risk premia over time."

33) Henderson, Brian J. (George Washington University) / Pearson, Neil D. / Wang, Li (University of Illinois at Urbana-Champaign) (2012): New Evidence on the Financialization of Commodity Markets: "Commodity-Linked Notes (CLNs) ... issuers hedge their liabilities by taking long positions in the underlying commodity futures on the pricing dates. These hedging trades are plausibly exogenous to the contemporaneous and subsequent price movements,

allowing us to identify the price impact of the hedging trades. We find that these hedging trades cause significant price changes in the underlying futures markets, and therefore provide direct evidence of the impact of "financial" trades on commodity futures prices."

34) Hong, Harrison (Princeton University) / Yogo, Motohiro (University of Pennsylvania) (2009): Digging into Commodities: „Since 2004 ... commodity prices have appreciated considerably, and aggregate basis has fallen (if anything), suggesting that futures prices have responded at least (if not more than) one-for-one with spot-price shocks. This could reflect the belief among investors that these price shocks are permanent or highly persistent. This is however unprecedented since even during the energy crisis of the seventies, one did not see such a striking movement in futures prices. This finding could instead reflect the conventional wisdom that lots of new indexed money flowed into commodity futures (as opposed to the spot market), chasing returns during this period."

35) Inamura, Yasunari / Kimata, Tomonori / Takeshi, Kimura / Muto, Takashi (Bank of Japan) (2011): Recent Surge in Global Commodity Prices – Impact of financialization of commodities and globally accommodative monetary conditions: „While the strong increase in commodity prices has been driven by global economic growth propelled by emerging economies, speculative investment flows into commodity markets have amplified the intensity of the price surge. (...) global commodity markets have become more sensitive to portfolio rebalancing by financial investors, which has made commodity markets more correlated with other asset markets, including major equity markets."

36) Jickling, Mark / Austin, Andrew D. (Congressional Research Service) (2011): Hedge Funds Speculation and Oil Prices: "A statistically significant correlation is evident between changes in positions held by "money managers" (a category of speculators that includes hedge funds) and the price of oil. In other words, during weeks when money managers have been net buyers of oil futures and options (or increased the size of their long positions), the price has tended to rise. Price falls, conversely, have tended to coincide with reductions in money managers' long positions."

37) Juvenal, Luciana / Ivan, Petrella (Federal Reserve Bank of St. Louis) (2011): „Speculation in the Oil Market: „We find that the increase in oil prices in the last decade is mainly due to the strength of global demand, consistent with previous studies. However, financial speculation significantly contributed to the oil price increase between 2004 and 2008."

38) Kawamoto, Takuji / Kimura, Takeshi / Morishita, Kentaro / Higashi, Masato (Bank of Japan) (2011): What has caused the surge in global commodity prices and strengthened cross-market linkage?: "Moreover, we find quantitative evidence that an increase in cross-market linkage between commodity and stock markets was caused by the markets' increased comovements due to large fluctuations in the global economy during the financial crisis as well as by the "financialization of commodities," that is, financial investors are increasingly treating commodities as an investment asset class."

39) Khan, Mohsin S. (Petersen Institute) (2009): The 2008 Oil Price "Bubble": "While market fundamentals obviously played a role in the general run-up in the oil prices from 2003 on, it is fair to conclude by looking at a variety of indicators that speculation drove an oil price bubble in the first half of 2008. Absent speculative activities, the oil price would probably have been in the $80 to $90 a barrel range."

40) Lagi, Marco / Bar-Yam, Yavni / Bertrand, Karla Z. / Bar-Yam, Yaneer (New England Complex Systems Insitute, Cambridge MA) (2011): The Food Crises A Quantitative Model of Food Prices Including Speculators and Ethanol Conversion: "The two sharp peaks in 2007/2008 and 2010/2011are specifically due to investor speculation, while an underlying upward trend is due to increasing demand from ethanol conversion. The model includes investor trend following as well as shifting between commodities, equities and bonds to take advantage of increased expected returns. Claims that speculators cannot influence grain prices are shown to be invalid by direct analysis of price setting practices of granaries." UPDATE (2012): "we extend the food prices model to January 2012, without modifying the model but simply continuing its dynamics. The agreement is still precise, validating both the descriptive and predictive abilities of the analysis."

41) Lammerding, Marc / Stephan, Patrick / Trede, Mark / Wilfling, Bernd (University of Münster): Speculative bubbles in recent oil price dynamics: Evidence from a Bayesian Markov-switching state-space approach: "we find robust evidence for the existence of speculative bubbles in recent oil price dynamics."

42) Le Pen, Yannick (Université Paris-Dauphine) / Sévi, Benoît (Aix-Marseille University) (2012): Futures Trading and the Excess Comovement of Commodity Prices: „Our estimates provide evidence of a time-varying excess comovement which is only occasionally significant, even after controlling for heteroscedasticity. Interestingly, excess comovement is mostly significant in recent years when a large increase in the trading of commodities is observed. However, we show that this increase in trading activity alone has no explanatory power for the excess comovement. Conversely, measures of hedging and speculative pressure explain around 60% of the estimated excess comovement thereby showing the strong impact of the financialization on the price of commodities and the fact that demand and supply variables are not the sole factors in determining equilibrium prices."

43) Liu, Peng (Cornell University) / Zhigang, Qui / Tang, Ke (Renmin University of China) (2011) Financial-Demand Based Commodity Pricing: A Theoretical Model for Financialization of Commodities: "In this paper, we develop an equilibrium model that shows that financial investment does influence commodity prices and volatilities. Furthermore, financial investments dilute the relationship between convenience yields (a proxy for the fundamentals) and commodity prices."

44) Lombardi, Marco J. / Van Robays, Ine (European Central Bank) (2011): Do financial investors destablize the oil price?: "We find that financial investors in the futures market can destabilize oil spot prices, although only in the short run. Moreover, financial activity appears to have exacerbated the volatility in the oil market over the past decade, particularly in 2007-2008. However, shocks to oil demand and supply. remain the main drivers of oil price swings."

45) Luciani, Giacomo (Gulf Research Center Foundation) (2009): From Price Taker to Price Maker? Saudi Arabia and the World Oil Market: "The inflow of liquidity, the increasing role played by the futures market (paper barrels) over the spot (wet barrels), and the proliferation of derivatives which encourage betting on price changes rather than on the absolute level of prices all contribute to worsen the situation, amplifying price oscillations."

46) Mayer, Jörg (UNCTAD) (2009): The Growing Interdependence between Financial and Commodity Markets: "The increasing importance of financial investment

in commodity trading appears to have caused commodity futures exchanges to function in such a way that prices may deviate, at least in the short run, quite far from levels that would reliably reflect fundamental supply and demand factors. Financial investment weakens the traditional mechanisms that would prevent prices from moving away from levels determined by fundamental supply and demand factors – efficient absorption of information and physical adjustment of markets. This weakening increases the proneness of commodity prices to overshooting and heightens the risk of speculative bubbles occurring."

47) Medlock, Kenneth B. / Jaffe, Amy M. (Rice University) (2009): Who is in the Oil Futures Market and How Has It Changed?: "...trading strategies of some financial players in oil appears to be influencing the correlation between the value of the U.S. dollar and the price of oil. (...) We also find that the correlation between movements in oil prices and the value of the dollar against the trade-weighted index of the currencies of foreign countries has increased to 0.82 (a significant measure) for the period between 2001 and the present day, compared to a previously insignificant correlation of only 0.08 between 1986 and 2000."

48) Mou, Yiqun (Columbia University) (2010): Limits to Arbitrage and Commodity Index Investment: Frontrunning the Goldman Roll: "This paper focuses on the unique rolling activity of commodity index investors in the commodity futures markets and shows that the price impact due to this rolling activity is both statistically and economically significant."

49) Naylor, Rosamund L. / Falcon, Walter P. (Stanford University) (2010): Food Security in an Era of Economic Volatility: „Uncertainty surrounding exchange rates and macro policies added to price misperceptions, as did flurries of speculative activity in organized futures markets. Events since 2005 – including the most recent period of price variability in 2010 – underscore the point that uncertainty and expectations can be as important as or even more important than actual changes in grain demand and supply in driving price variability."

50) Nissanke, Machiko (University of London) (2011): Commodity Markets and Excess Volatility. Sources and Strategies to Reduce Adverse Development Impacts: "Thus, commodity prices, as prices of any assets traded globally, can be largely influenced by market liquidity cycles in global finance. From this particular perspective, we can have a plausible narrative of the recent episode of commodity price cycle. (...) Clearly, trading activities in world commodity markets have undergone some fundamental change, as the links between activities in commodity and financial markets has further intensified."

51) Peri, Massimo / Vandone, Daniela / Baldi, Luca (Università degli studi di Milano) (2012): Internet, Noise Trading and Commodity Prices: "Moreover, results show that variations in information demand have a significant effect on corn futures volatility, and this effect is robust even when controlling for variations in the supply of information. This result is relevant since it can be interpreted in light of behavioural finance, where studies consider information demand as an expression of noise trading: the search of information on commodity prices through internet by noise traders can amplify volatility especially in case of negative shock, when investment decisions are more easily influenced by panic or irrational behavior."

52) Phillips, Peter C. B. (Yale University) / Yu, Jun (Singapore University) (2010): Dating the Timeline of Financial Bubbles During the Subprime Crisis: "a bubble first emerged in the equity market during mid-1995 lasting to the end of 2000, followed by a bubble in the real estate market between September 2000 and June 2007 and in the mortgage market between August 2005 and July 2007. After the subprime crisis erupted, the phenomenon migrated selectively into the commodity market and the foreign exchange market, creating bubbles which subsequently burst at the end of 2008, just as the effects on the real economy and economic growth became manifest."

53) Pollin, Robert / Heintz, James (University of Massachusetts) (2011): How Wall Street Speculation is Driving Up Gasoline Prices Today: "A major additional factor is the rapid growth in large-scale speculative trading around oil prices through the oil commodities futures market. Indeed, we estimate that, without the influence of large-scale speculative trading on oil in the commodities futures market, the average price of gasoline at the pump in May would have been $3.13 rather than $3.96."

54) Ray, Darryl E. / Schaffer, Harwood D. (University of Tennessee) (2010): Index funds and the 2006-2008 run-up in agricultural commodity prices: "the fundamentals and/or expectations in the energy and mineral markets rein supreme—grains are along for the ride with little-to-no regard to what is happening in the grain sector. Worries during the period about the availability of oil drove up the price of crude, which caused index funds to rebalance their portfolios by making additional purchases of the other commodities to maintain the specified balance. Since the resulting price increases in agricultural commodities had virtually nothing to do with their market conditions, the record level of activity in the futures market by index funds would seem to make index funds a logical source of possible price overshooting."

55) Robles, Miguel / Torero, Maximo / Braun, Joachim von (IFPRI) (2009): When speculation matters: „Changes in supply and demand fundamentals cannot fully explain the recent drastic increase in food prices. Rising expectations, speculation, hoarding, and hysteria also played a role in the increasing level and volatility of food prices."

56) Schulmeister, Stephan (Vienna University) (2009): Trading Practices and Price Dynamics in Commodity Markets: "Based on the "bullishness" in commodity derivatives markets, short-term oriented speculators reacted much stronger to news in line with the expectation of rising prices than to news which contradicted the "market mood". Hence, they put more money into long positions than into short positions and held long positions longer than short positions. Due to this trading behavior, upward commodity price runs lasted longer in recent years than downward runs causing prices to rise in a stepwise process. Commodity price runs were lengthened by the use of trend-following trading systems of technical analysis. These systems try to exploit price runs by producing buy (sell) signals in the early stage of an upward (downward) run. The aggregate trading signals then feed back upon commodity prices."

57) Schulmeister, Stephan (Vienna University) (2012): Technical Trading and Commodity Price Fluctuations: "If one aggregates over the transactions and open positions of the 1,092 technical models, it turns out that technical commodity futures trading exerts an excessive demand (supply) pressure on commodity markets."

58) Singleton, Kenneth J. (Stanford University) (2010): The 2008 Boom/Bust in Oil Prices: „In my view, while spot-market supply and demand pressures were influential factors in the behavior of oil prices, so were participation in oil futures markets by hedge funds, long-term passive investors, and other traders in energy derivatives."

59) Singleton, Kenneth J. (Stanford University) (2011): Investor Flows And The 2008 Boom/Bust in Oil Prices: "there was an economically and statistically significant effect

of investor flows on futures prices... The intermediate-term growth rates of index positions and managed-money spread positions had the largest impacts on futures prices."

60) Sockin, Michael / Xiong, Wei (Princeton University) (2012): Feedback Effects of Commodity Futures Prices: "A s a result of information frictions and production complementarity, increases in the futures prices, even if driven by non-fundamental reasons, can lead to increased, rather than decreased, commodity demand and thus spot prices. This outcome contradicts two widely held arguments that speculators who trade only in futures markets cannot a¤ect spot prices and that commodity price increases driven by non-fundamental reasons must be accompanied by inventory spikes."

61) Timmer, C. Peter (Center for Global Development, Washington) (2009): Peter Timmer: Peter Timmer: Did Speculation Affect World Rice Prices?: „Speculative money seems to surge in and out of commodity markets, strongly linking financial variables with commodity prices during some time periods. But these periods are often short and the relationships disappear entirely for long periods of time."

62) Tse, Yiuman / Williams, Michael (University of Texas at San Antonio) (2011): Does Index Speculation Impact Commodity Prices?: "We conclude that speculative pressures exerted by commodity index investors can impact non-index commodities. These results are likely not due to speculative pressure itself, but rather the subsequent price destabilizing trades of uninformed, positive feedback traders."

63) Tse, Yiuman (University of Texas at San Antonio) (2012): The Relationship Among Agricultural Futures, ETFs, and the US Stock Market: "I find that Granger-causality in returns primarily runs from individual futures to the agriculture ETFs. However, DBA and RJA returns are also significantly caused by S&P500 index returns, showing that stock market sentiment influences pricing behavior. The results are also consistent with the impact of financialization of commodities on agriculture prices."

64) Van der Molen, Maarten (University of Utrecht) (2009): Speculators invading the commodity markets: a case study of coffee: „The results indicate that index speculators frustrated the futures market in the period between 2005 and 2008. This conclusion is based on the following indications: fundamentals have a lower impact on the price, the volume of index speculators has increased and their ability to influence the futures market has increased."

65) Vansteenkiste, Isabel (European Central Bank) (2011): What is driving oil price futures? Fundamentals versus Speculation: "We find that for the earlier part of our sample (up to 2004) that fundamentals have been the key driving force behind oil price movements. Thereafter, trend chasing patterns appear to be better in capturing the developments in oil futures markets."

66) Varadi, Vijay Kumar (ICRIER) (2012): An evidence of speculation in Indian commodity markets: "results exhibit that speculation has played decisive role in the commodity price bubble during the global crisis in India."

67) Von Braun, Joachim (Bonn University), Tadesse, Getaw (IFPRI) (2012): Global Food Price Volatility and Spikes: An Overview of Costs, Causes and Solutions: "The general conclusion on price spikes is that they were driven by excessive volumes of futures trading more than by demand side (oil price) and supply side shocks."

68) Windawi, A. Jason (Columbia University) (2012): Speculation, Embedding, and Food Prices. A Cointegration Analysis: „The Wheat Granger test results show a clustering of speculative financial influences on wheat prices in the period from early 2006 through June of 2010, with a particularly strong increase in the four subperiods beginning with the first drop in prices. (...) Like the wheat tests, the Granger results for Corn ... were clustered around the first wave of the food crisis..."

69) Wray, Randall L. (University of Missouri-Kansas City) (2008): The Commodities Market Bubble – Money Manager Capitalism and the Financialization of Commodities "There is adequate evidence that financialization is a big part of the problem, and there is sufficient cause for policymakers to intervene with sensible constraints and oversight to reduce the influence of managed money in these markets."

C) Research papers and testimonies by analysts and traders

1) Berg, Ann (former CBoT trader and director, now FAO advisor) (2011): The rise of commodity speculation: from villainous to venerable: "Structural changes in global commodity markets have greatly contributed to rising prices and increased price variability. These fundamental trends toward higher prices have been a key lure for increased speculative activity on the major futures exchanges."

2) Bukold, Steffen (2010) (Energycomment): Ölpreisspekulation und Benzinpreise in Deutschland: "Traditionelle Erklärungen, die nur auf den physischen Ölmarkt schauen, sind nicht hilfreich: Ein Überangebot an Rohöl, schwache Nachfrage und überquellende Lager hätten zu sinkenden, bestenfalls stagnierenden Rohölpreisen führen müssen. Die Erklärung liegt im starken Engagement von Finanzinvestoren, die Öl (genauer: Öllieferkontrakte) aus spekulativen Gründen kaufen, d.h. auf höhere Ölpreise wetten. Der Rohölmarkt ist dadurch noch stärker als bisher zu einem Hybridmarkt geworden, also einer Mischung aus Rohstoffmarkt und Finanzmarkt."

3) Cooper, Marc (Consumer Federation of America) (2011): Excessive Speculation and Oil Price Shock Recessions: A Case of Wall Street "Déjà vu all over again": "the paper shows that excessive speculation, not market fundamentals caused the spike in oil prices. The movement of trading and prices in the three years since the speculative bubble in oil burst in 2008 provides even stronger evidence that excessive speculation is a major problem that afflicts the oil market and the economy."

4) Deutsche Bank Research (2009): Do speculators drive crude oil prices? Dispersion in beliefs as price determinants: "The econometric estimates can reject the null hypotheses that the dispersion in beliefs of speculators has no influence on the crude oil price and its volatility. Both the Granger causality tests and the distributed lag models, which also include lagged regressors that measure the dispersion in beliefs of speculators, confirm moreover the role of speculation as a precursor to price movements.."

5) Dicker, Dan (former NYMEX trader) (2011): "I wrote Oil's Endless Bid to show how the treatment of oil as a stock by investors, far more than any number of globally significant competing factors, causes the dramatically higher prices that we've seen in recent years. I've witnessed seismic changes to the oil markets during my many years as a trader, and it's the everyday consumer who shoulders the burden."

6) Goldman Sachs (2011): Global Energy Weekly March 2011: "We estimate that each million barrels of net speculative length tends to add 8-10 cents to the price of a barrel of oil."

7) Evans, Tim (Citigroup energy analyst) (2008): The Official Demise of the Oil Bubble (Wall Street Journal article): "This is a market that is basically returning to the price level of a year ago which it arguably should never have left. (...) We pumped up a big bubble, expanded it to an impressive dimension, and now it is popped and we have bubble gum in our hair."

8) Frenk, David (Better Markets) (2010): Review of Irwin and Sanders 2010 OECD report: "1) The statistical methods applied are completely inappropriate for the data used. 2) The study is contradicted by the findings of other studies that apply more appropriate statistical methods to the same data. 3) The overall analysis is superficial and easily refuted by looking at some basic facts."

9) Frenk, David / Turbeville, Wallace C. (Better Markets) (2011): Commodity Index Traders and the Boom/Bust Cycle in Commodities Prices: "We find strong evidence that the CIT Roll Cycle systematically distorts forward commodities futures price curves towards a contango state, which is likely to contribute to speculative "boom/bust" cycles by changing the incentives of producers and consumers of storable commodities, and also by sending misleading and non-fundamental, price signals to the market."

10) Gheit, Fadel / Katzenberg, Daniel (2008) (Oppenheimer & Co.): Surviving lower oil prices: "The investment banks that hyped oil prices using voodoo economics have suddenly reversed their position and now expect much lower oil prices. They helped cause excessive speculation, create the oil bubble, and contributed to the global financial crisis. They have changed their tune in exchange for a government bailout, not because of changes in market fundamentals."

11) Hunt, Simon (Simon Hunt Strategic Services) (2011): "Slowly, the truth on whether the global copper market is really tight is coming out. It illustrates just how large an involvement the financial institutions have become to the copper industry. It shows, too, that by throwing money at a market, prices can be driven higher. In the process, however, the delicate balance between supply and the industry's requirements for a basic material used to produce a range of essential products is destroyed. In short, copper is becoming a financial asset in place of its historic role as an industrial metal."

12) Kemp, John (Reuters) (2008): Crisis remakes the commodity business: "It does not alter the fact most of the upsurge in futures and options turnover on commodity exchanges and in OTC markets over the last five years has come from investment-related rather than trade-related business."

13) Korzenik, Jeffrey (CIO, Caturano Wealth Management) (2009): Fundamental Misconceptions in the Speculation Debate: "'Overspeculation' or 'excessive speculation' exists when speculators become primary drivers of price. When this happens, commodities are no longer efficiently allocated – if prices are driven below the point where commercial supply and demand meet, shortages result."

14) Lake Hill Capital Management (2013): Investable indices are distorting commodities and futures: "...it is important to recognize that institutional and retail indexing demand can create price distortions that cloud the fundamental picture. Increased indexing leads to steeper futures term structures, and this results in more costly exposure."

15) Lines, Thomas (commodity consultant) (2010): Speculation in food commodity markets: "These are the main problems that are caused by long-only index trading: It pushes prices up, irrespective of the market situation. It disrupts the rolling over of futures contracts when the nearest month expires."

16) Masters, Michael W. (Masters Capital) / White, Adam K. (White Knight Research) (2008): The Accidental Hunt Brothers: "Index Speculators have bought more commodities futures contracts in the last five years than any other group of market participant. They are now the single most dominant force in the commodities futures markets. And most importantly, their buying and trading has nothing to do with the supply and demand fundamentals of any single commodity. They pour money into commodities futures to diversify their portfolios, hedge against inflation or bet against the dollar."

17) Morse, E. (former Lehman Brothers chief energy economist) (2008): Oil Dotcom, Research Note: "Fundamental changes cannot explain sudden, severe price or curve movements. (...) Our conclusion from this study is that we are seeing the classic ingredients of an asset bubble."

18) Newell, J. (Probability Analytics Research) (2008): Commodity Speculation's "Smoking Gun": "Real market forces in these diverse markets are largely independent of one another, and therefore price changes should be essentially uncorrelated. This was clearly true historically; from 1984 through 1999 average correlation between all commodities was only 7%. In the last 12 months this average rose to 64%. Correlation with the GSCI was 23% historically, and rose to 76% in the last year. Index speculation has swamped real market forces."

19) Petzel, Todd E. (Offit Capital Advisors) (2009): Testimony before the CFTC: „I believe these investors in aggregate have had a material impact on price levels, price spreads and the level of inventories being held."

20) Soros, George (2008): Interview with Stern: "Speculators create the bubble that lies above everything. Their expectations, their gambling on futures help drive up prices, and their business distorts prices, which is especially true for commodities. It is like hoarding food in the midst of a famine, only to make profits on rising prices. That should not be possible."

21) Tudor Jones, Paul (Tudor Investment Corporation) (2010): Price Limits: A Return to Patience and Rationality in U.S. Markets. Speech to the CME Global Financial Leadership: "Every exchange traded instrument including all securities, futures, options and any other form of derivatives should have some form of a price limit. And this is all the more urgently needed now that electronic execution dominates trading."

22) Urbanchuk, John M. (Cardno ENTRIX) (2011): Speculation and the Commodity Markets: "A careful examination of activity by non-commercial and index traders (i.e. speculators) in the corn futures market in the context of supply and demand fundamentals strongly suggests that speculation is a major factor behind the sharp increase in both the level and volatility of corn prices this year."

23) Woolley, Paul (former fund manager, York University / London School of Economics) (2010): Why are financial markets so inefficient and exploitative – and a suggested remedy: "With the flood of passive and active investment funds going into commodities from 2005 onwards, prices have been increasingly driven by fund inflows rather than fundamental factors. Prices no longer provide a reliable signal to producers or consumers."

D) Reports by public institutions

1) Chevalier, Jean-Marie (ed.) (Ministère de l'Economie, de l'Industrie et de l'Emploi) (2010): Rapport du groupe de travail sur la volatilité des prix du pétrole: "On peut raisonnablement avancer en conclusion que le jeu de certains acteurs financiers a pu amplifier les mouvements à la hausse ou à la baisse des cours, augmentant la volatilité naturelle des prix du pétrole..."

2) House of Commons Select Committee on Science & Technology of the United Kingdom (2011): "While the debate on the relative importance of the multiple factors influencing commodities prices is still open, it is clear that price movements across different commodity markets have become more closely related and that commodities markets have become more closely linked to financial markets."

3) Jouyet, Jean-Pierre (President de l'Autorite des marches financiers) / de Boissieu, Christian (President du Conseil d'analyse economique) / Guillon, Serge (Controleur general economique et financier) (2010): Rapport d'étape – Prévenir et gérer l'instabilité des marchés agricoles: "Les marchés agricoles sont confrontes a une mondialisation et a une financiarisation qui influencent leur fonctionnement. La volatilité naturelles des prix qui caractérise ces marches est amplifiée par de nouveaux facteurs et notamment par une speculation excessive."

4) Schutter, Olivier de (UN Special Rapporteur on the Right to Food) (2010): Food commodities speculation and food price crises: Regulation to reduce the risks of financial volatility: "The global food price crisis that occurred between 2007 and 2008 ... had a number of causes. The initial causes related to market fundamentals, including the supply and demand for food commodities, transportation and storage costs, and an increase in the price of agricultural inputs. However, a significant portion of the increases in price and volatility of essential food commodities can only be explained by the emergence of a speculative bubble."

5) Tanaka, Nobuo (head International Energy Agency) (2009): IEA says speculation amplifying oil prices moves (Reuters article): "Our analysis shows that the fundamentals are deciding the direction of the price while these funds or speculations ... are amplifying the movement."

6) United Nations Conference on Trade and Development (UNCTAD) (2009): Trade and Development Report, Chapter II – The Financialization of Commodity Markets: "The financialization of commodity futures trading has made commodity markets even more prone to behavioural overshooting. There are an increasing number of market participants, sometimes with very large positions, that do not trade based on fundamental supply and demand relationships in commodity markets, but, who nonetheless, influence commodity price developments."

7) United Nations Conference on Trade and Development (UNCTAD) (2009): The global economic crisis: Systemic failures and multilateral remedies: "The evidence to support the view that the recent wide fluctuations of commodity prices have been driven by the financialization of commodity markets far beyond the equilibrium prices is credible. Various studies find that financial investors have accelerated and amplified price movements at least for some commodities and some periods of time. (...) The strongest evidence is found in the high correlation between commodity prices and the prices on other markets that are clearly dominated by speculative activity."

8) United Nations Conference on Trade and Development (UNCTAD) (2011): Price Formation in Financialized Commodity Markets: the Role of Information: "Due to the increased participation of financial players in those markets, the nature of information that drives commodity price formation has changed. Contrary to the assumptions of the efficient market hypothesis (EMH), the majority of market participants do not base their trading decisions purely on the fundamentals of supply and demand; they also consider aspects which are related to other markets or to portfolio diversification. This introduces spurious price signals to the market."

9) United Nations Commission of Experts on Reforms of the International and Monetary System (2009): Report: "In the period before the outbreak of the crisis, inflation spread from financial asset prices to petroleum, food, and other commodities, partly as a result of their becoming financial asset classes subject to financial investment and speculation."

10) United Nations Food and Agricultural Organisation (FAO) (2010): Final report of the committee on commodity problems: Extraordinary joint intersessional meeting of the intergovernmental group (IGG) on grains and the intergovernmental group on rice: "Unexpected crop failure in some major exporting countries followed by national responses and speculative behaviour rather than global market fundamentals, have been amongst the main factors behind the recent escalation of world prices and the prevailing high price volatility."

11) United Nations Food and Agricultural Organisation (FAO) (2010). Price Volatility in Agricultural Markets. Economic and Social Perspectives Policy Brief 12: "Financial firms are progressively investing in commodity derivatives as a portfolio hedge since returns in the commodity sector seem uncorrelated with returns to other assets. While this 'financialisation of commodities' is generally not viewed as the source of price turbulence, evidence suggests that trading in futures markets may have amplified volatility in the short term."

12) United Nations Food and Agricultural Organisation (FAO), IFAD, IMF,OECD, UNCTAD, WFP,The World Bank, The WTO, IFPRI, UN HLTF (2011): Price Volatility in Food and Agricultural Markets: Policy Responses: "While analysts argue about whether financial speculation has been a major factor, most agree that increased participation by non-commercial actors such as index funds, swap dealers and money managers in financial markets probably acted to amplify short term price swings and could have contributed to the formation of price bubbles in some situations."

13) United States Senate, Permanent Subcommittee on Investigations (2007): Excessive Speculation in the Natural Gas Market: "Amaranth's 2006 positions in the natural gas market constituted excessive speculation. (...) Purchasers of natural gas during the summer of 2006 for delivery in the following winter months paid inflated prices due to Amaranth's speculative trading."

14) United States Senate, Permanent Subcommittee on Investigations (2009): Excessive Speculation in the Wheat Market: "This Report concludes there is significant and persuasive evidence that one of the major reasons for the recent market problems is the unusually high level of speculation in the Chicago wheat futures market due to purchases of futures contracts by index traders offsetting sales of commodity index instruments."

15) United States Senate, Permanent Subcommittee on Investigations (2006): The Role of Market Speculation in Rising Oil and Gas Prices: "The large purchases of crude oil futures contracts by speculators have, in effect, created an additional demand for oil, driving up the price of oil to be delivered in the future in the same manner that additional demand for the immediate delivery of a physical barrel of oil drives up the price on the spot market."

Appendix B

38 Independent Studies on the Negative Effects of High Speed Trading on Commodity Markets

38 Studies on the Harm Caused By High Frequency Trading

Author(s), Title, Year	Data	Relevant findings
Anand, Tanggaard, Weaver, "Paying for Market Quality" (2009)	Swedish equities, 2002-2004	Designated market makers with affirmative obligations improve market quality, increase market valuation.
Bank for International Settlements, "High frequency trading in the foreign exchange market" (2011)	Foreign exchange, 2010 and 2011	"HFT has had a marked impact on the functioning of the FX market in ways that could be seen as beneficial in normal times, but also in ways that may be harmful to market functioning, particularly in times of market stress."
Bichetti, Maystre, "The synchronized and long-lasting structural change on commodity markets: evidence from high frequency data" (2012) (Added 3/2012)	U.S. futures and equities, 1997-2011	"This paper documented striking similarities in the evolution of the rolling correlations between the returns on several commodity futures and the ones on the US stock market, computed at high frequencies...we think that HFT strategies, in particular the trend-following ones, are playing a key role...commodity markets are more and more prone to events in global financial markets and likely to deviate from their fundamentals."
Boehmer, Fong, Wu, "International Evidence on Algorithmic Trading" (2012) (Added 3/2012)	Equities in 37 countries (excluding U.S.), 2001-2009	"Overall, our results show that algorithmic trading often improves liquidity, but this effect is smaller when market making is difficult and for low-priced or high-volatility stocks. It reverses for small cap stocks, where AT is associated with a decrease in liquidity. AT usually improves efficiency. The main costs associated with AT appear to be elevated levels of volatility. This effect prevails even for large market cap, high price, or low volatility stocks, but it is more pronounced in smaller, low price, or high volatility stocks."
Chae, Wang, "Determinants of Trading Profits: The Liquidity Provision Decision" (2009)	Taiwanese equities, 1997-2002	Absent mandatory obligations, market maker privileges don't induce market makers to provide liquidity; privileged but unconstrained market makers make profits when demanding liquidity in their own informed trades; unconstrained market makers are informed traders rather than liquidity providers in most scenarios.
Easley, Lopez del Prado, O'Hara, "The Microstructure of the Flash Crash" (2011)	U.S. futures, 2010	Unregulated or unconstrained HFT market makers can exacerbate price volatility when they dump inventory and withdraw, flash crashes will recur because of structural issues.
Egginton, Van Ness, Van Ness, "Quote Stuffing" (2012) (Added 3/2012)	U.S. equities, 2010	"We find that quote stuffing is pervasive with several hundred events occurring each trading day and that quote stuffing impacts over 74% of US listed equities during our sample period. Our results show that, in periods of intense quoting activity, stocks

		experience decreased liquidity, higher trading costs, and increased short-term volatility. Our results suggest that the HFT strategy of quote stuffing may exhibit some features that are criticized in the media."
Ferguson, Mann, "Execution Costs and Their Intraday Variation in Futures Markets" (2001)	U.S. futures, 1992	Unregulated or unconstrained market makers in the futures market have much more rapid inventory cycles than (regulated) equity market makers, are active rather than passive traders, and "actively trade for their own accounts, profiting from their privileged access..."
Frino, Forrest, Duffy, "Life in the pits: competitive market making and inventory control-further Australian evidence" (1999)	Australian futures, 1997	Unregulated or unconstrained market makers are not passive liquidity providers, they behave aggressively like informed traders.
Frino, Jarnecic, "An empirical analysis of the supply of liquidity by locals in futures markets: Evidence from the Sydney Futures Exchange" (2000)	Australian futures, 1997	Unregulated or unconstrained market makers demand liquidity to profit from information advantages of privileged access, less likely to supply liquidity in volatile markets, almost as likely to demand as to supply liquidity.
Frino, Jarnecic, Feletto, "Local Trader Profitability in Futures Markets: Liquidity and Position Taking Profits" (2009)	Australian futures, 1997	Unregulated or unconstrained market makers are active and informed traders.
Golub, Keane, "Mini Flash Crashes" (2011) (Added 3/2012)	U.S. equities, 2006-2010	"As soon as the [HFT] market maker's risk management limits are breached...the market maker has to stop providing liquidity and start to aggressively take liquidity, by selling back the shares bought moments earlier. This way they push the price further down and thus exaggerate the downward movement."
Hautsch, Huang, "On the Dark Side of the Market: Identifying and Analyzing Hidden Order Placements" (2012) (Added 3/2012)	U.S. equities, 2010	"Using data from the NASDAQ TotalView message stream allows us to retrieve information on hidden depth from one of the largest equity markets in the world."
Hirschey, "Do High-Frequency Traders Anticipate Buying and Selling Pressure?" (2011) (Added 3/2012)	U.S. equities, 2009	"HFTs' aggressive purchases predict future aggressive buying by non-HFTs, and their aggressive sales predict future aggressive selling by non-HFTs"; "These findings suggest HFTs trade on forecasted price changes caused by buying and selling pressure from traditional asset managers." The author writes that "On net, it is probable

		HFTs have a positive impact on market quality" because of tighter spreads; investment managers might disagree.
Johnson, Zhao, Hunsader, Meng, Ravindar, Carran, Tivnan, "Financial black swans driven by ultrafast machine ecology" (2012) (Added 3/2012)	U.S. equities, 2006-2011	The authors study "18,520 ultrafast black swan events that we have uncovered in stock-price movements between 2006 and 2011" and find "an abrupt system-wide transition from a mixed human-machine phase to a new all-machine phase characterized by frequent black swan events with ultrafast durations."
Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues, "Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010" (2011)	U.S. futures and equities, 2010	"In the present environment, where high frequency and algorithmic trading predominate and where exchange competition has essentially eliminated rule-based market maker obligations, liquidity problems are an inherent difficulty that must be addressed. Indeed, even in the absence of extraordinary market events, limit order books can quickly empty and prices can crash simply due to the speed and numbers of orders flowing into the market and due to the ability to instantly cancel orders."
Kim, Murphy, "The Impact of High-Frequency Trading on Stock Market Liquidity Measures" (2011) (Added 3/2012)	U.S. equities, 1997-2009	Traditional market microstructure models have significantly underestimated market spreads in recent years. This is because of how trade sizes have decreased with the recent dominance of high frequency trading. When the authors correct for this they find that spreads have not decreased as much as HFT proponents believe.
Kirilenko, Samadi, Kyle, Tuzun, "The Flash Crash: The Impact of High Frequency Trading on an Electronic Market" (2010)	U.S. futures, 2010	Unregulated or unconstrained HFT market makers exacerbated price volatility in the Flash Crash, hot potato trading, two minute market maker inventory half-life; "...High Frequency Traders exhibit trading patterns inconsistent with the traditional definition of market making. Specifically, High Frequency Traders aggressively trade in the direction of price changes...when rebalancing their positions, High Frequency Traders may compete for liquidity and amplify price volatility."
Kurov, Lasser, "Price Dynamics in the Regular and E-Mini Futures Markets" (2004)	U.S. futures, 2001	Unregulated or unconstrained market makers demand liquidity to profit from information advantages of privileged access.
Linton, O'Hara, "The impact of computer trading on liquidity, price efficiency/ discovery and transaction costs" (2011)	Literature review and survey	"The nature of market making has changed, shifting from designated providers to opportunistic traders. High frequency traders now provide the bulk of liquidity, but their use of limited capital combined with ultra-fast speed creates the potential for periodic illiquidity"; in "regular market conditions,"

		liquidity has improved and transaction costs are lower.
Locke, Sarajoti, "Interdealer Trading in Futures Markets" (2004)	U.S. futures, 1995	Unregulated or unconstrained market makers demand liquidity to manage inventories.
Lyons, "A Simultaneous Trade Model of the Foreign Exchange Hot Potato" (1997)	Model derived from empirical studies of 1992 U.S. foreign exchange market.	Demonstrates hot potato trading among unregulated or unconstrained market makers. "Hot potato trading" means cascading inventory imbalances from market maker to market maker in response to a large order. Hot potato trading explains most of the volume in foreign exchange markets. Hot potato trading is not innocuous - it makes prices less informative.
Lyons, "Foreign exchange volume: Sound and fury signifying nothing?" (1996)	U.S. foreign exchange, 1992	Unregulated or unconstrained market makers cascade inventory imbalances from one to another, as "...trading begets trading. The trading begotten is relatively uninformative, arising from repeated passage of inventory imbalances among dealers...this could not arise under a specialist microstructure."
Manaster, Mann, "Life in the pits: competitive market making and inventory control" (1996)	U.S. futures, 1992	Unregulated or unconstrained market makers aggressively manage inventory, are "active profit-seeking," have much shorter inventory cycles than equities market makers.
Manaster, Mann, "Sources of Market Making Profits: Man Does Not Live by Spread Alone" (1999)	U.S. futures, 1992	Unregulated or unconstrained market makers demand liquidity to profit from information advantages of privileged access, are "predominant" informed traders.
McInish, Upson "Strategic Liquidity Supply in a Market with Fast and Slow Traders" (2012) (Added 3/2012)	U.S. equities, 2008	"We model and show empirically that latency differences allow fast liquidity suppliers to pick off slow liquidity demanders at prices inferior to the NBBO. This trading strategy is highly profitable for the fast traders."; "[O]ur research focuses on the ability of fast liquidity suppliers to use their speed advantage to the detriment of slow liquidity demanders, which we believe unambiguously lowers market quality. The ability of fast traders to take advantage of slow traders is exacerbated in the U.S. by the regulatory and market environment that we describe below."
Panayides, "Affirmative obligations and market making with inventory" (2007)	U.S. equities, 1991 and 2001	Mandatory market maker obligations reduce volatility.
Silber, "Marketmaker Behavior in an Auction Market: An Analysis of Scalpers in Futures Markets", (1984)	U.S. futures, 1982-1983	Unregulated or unconstrained market makers profit from the information advantages of privileged access, two minute inventory cycles.

Smidt, "Trading Floor Practices on Futures and Securities Exchanges: Economics, Regulation, and Policy Issues" (1985)	Literature review and survey	On futures exchanges, inventory imbalances among unregulated or unconstrained market makers create "potentially unstable" markets and price overreactions during "scalper inventory liquidation."
United States Commodity Futures Trading Commission and Securities and Exchange Commission, "Findings Regarding the Market Events of May 6, 2010" (2010)	U.S. futures and equities, 2010	Unregulated or unconstrained HFT market makers exacerbated price volatility in the Flash Crash, hot potato trading.
United States Federal Trade Commission, "Report of the Federal Trade Commission on the Grain Trade," Volume 7 (1926)	U.S. futures, 1915-1922	Unregulated or unconstrained market makers both cause and exacerbate price volatility; "The scalpers who operate with reference to fractional changes within the day may have a stabilizing effect on prices so far as such changes with the day are concerned, but when the market turns they run with it, and they may accentuate an upward or downward movement that is already considerable."
Van der Wel, Menkveld, Sarkar, "Are Market Makers Uninformed and Passive? Signing Trades in the Absence of Quotes" (2009)	U.S. futures, 1994-1997	Unregulated or unconstrained market makers demand liquidity for a substantial part of the day and are active and informed speculators.
Van Kervel, "Liquidity: What You See is What You Get?" (2012) (Added 3/2012)	U.K. equities, 2009	"We show that a specific type of high-frequency traders, those who operate like modern day market makers, might in fact cause a strong overestimation of liquidity aggregated across trading venues. The reason is that these market makers place duplicate limit orders on several venues, and after execution of one limit order they quickly cancel their outstanding limit orders on competing venues. As a result, a single trade on one venue is followed by reductions in liquidity on all other venues."
Venkataraman, Waisburd, "The Value of the Designated Market Maker" (2006)	French equities, 1995-1998	Designated market makers with affirmative obligations improve market quality, increase market valuation.
Wang, Chae, "Who Makes Markets? Do Dealers Provide or Take Liquidity?" (2003)	Taiwanese equities, 1997-2002	Absent mandatory obligations, market maker privileges don't induce market makers to provide liquidity; they derive profits from their own informed trades; "While dealers may be meant to perform the socially beneficial function of liquidity provision, the institutional advantages granted to them also give the ability to act as super-efficient proprietary traders if they choose to."

Working, "Tests of a Theory Concerning Floor Trading on Commodity Exchanges" (1967)	U.S. futures, 1952	Unregulated or unconstrained market makers are also trend traders, profiting from the information advantages of privileged access; they can trade aggressively, especially when the market goes against the firm; inventory cycles of "minutes"; trend trading accelerates price changes (but may moderate extremes).
Zhang, "High-Frequency Trading, Stock Volatility, and Price Discovery" (2010) (Added 3/2012)	U.S. equities, 1985-2009	"[H]igh-frequency trading may potentially have some harmful effects" because "high-frequency trading is positively correlated with stock price volatility."
Zigrand, Cliff, Hendershott, "Financial stability and computer based trading" (2011)	Literature review and survey	Self-reinforcing feedback loops in computer-based trading can lead to significant instability in financial markets; market participants become inured to excessive volatility in a cultural "normalization of deviance" until a large-scale failure occurs; research to date has not shown a persistent increase in market volatility, but HFT research is nascent.

National Grain and Feed Association

1250 Eye St., N.W., Suite 1003, Washington, D.C. 20005-3922, Phone: (202) 289-0873, FAX: (202) 289-5388, Web Site: www.ngfa.org

TESTIMONY OF THE

NATIONAL GRAIN AND FEED ASSOCIATION

TO THE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

UNITED STATES SENATE

JULY 17, 2013

Good afternoon, Chairwoman Stabenow, Ranking Member Cochran, and members of the committee. I am John Heck, Senior Vice President of The Scoular Company in Omaha, Nebraska. The Scoular Company, founded in 1892, manages commodity supply-chain risk for customers in food, feed and renewable fuel markets. From more than 70 locations across North America, nearly 700 Scoular employees tailor risk-management solutions for their customers by buying, selling, storing and transporting grain and ingredients.

Today, I am testifying on behalf of the National Grain and Feed Association (NGFA), the national trade association representing more than 1,000 companies including grain elevators, feed manufacturers, processors and other commercial businesses that utilize exchange-traded futures contracts to hedge their risk and assist producers in their marketing and risk management strategies. We appreciate the opportunity to testify before the committee today.

CFTC's Customer Protection Proposal -- Customer Protection and Customer Risk

For many years, grain hedgers and the futures commission merchants (FCMs) with whom they work to manage their risk have relied on a consistent interpretation of the Commodity Exchange Act by the Commodity Futures Trading Commission (CFTC) with regard to posting margin funds to their hedge accounts. Unfortunately, in the name of customer protection, that interpretation recently has been thrown into question by a new proposal from the CFTC that we believe would dramatically increase customer risk.

The CFTC currently is evaluating comments submitted with regard to this proposed rule, issued November 14, 2012, that seeks to bolster futures customer protections – a laudable goal. However, two very troublesome provisions in the proposed rule would have the perverse effect of increasing financial risk to futures customers – and in the process, dramatically changing the way business has been conducted in futures markets for decades.

One provision concerns the timing of when an FCM is required to take a capital charge for undermargined accounts. Currently, customers have three days to make margin calls to their FCMs before the FCM is required to take a capital charge. As we read the CFTC proposal, that three-day period would be shortened to just one day. Even in today's environment of money moving electronically, a single day is not sufficient for all customers to make margin calls that quickly. We fear this provision would compel FCMs to require that customers pre-margin their accounts – especially the smaller and mid-size FCMs that are so important in providing service to futures customers in the agribusiness and production agriculture spaces.

The second provision potentially is even more troublesome and more expensive to futures customers. It would change the timing of FCMs' calculation of residual interest for futures accounts – in other words, it appears the proposal would require all customers to be fully margined at all times. While this may sound like common sense, it is a huge departure from the CFTC's interpretation for decades that FCMs be allowed a certain period of time to "top up" hedge accounts while they wait for customers to make margin calls. This new proposal would lead to one of two outcomes: either the FCM would have to move more of its own funds (i.e., residual interest) into customers' hedge accounts; or FCMs would be forced to require pre-margining and, perhaps, intra-day margining, to ensure that each individual customer is fully margined at any moment.

The practical end result would be that futures customers would be required to send much more money to their FCMs in advance in anticipation of futures market moves that might never happen. Some customers likely would exit futures markets in favor of lower-cost risk management alternatives. We believe this potential exodus from futures markets would be most clearly seen among agricultural producers who utilize futures for risk management purposes and among smaller grain-hedging firms.

Taken to its logical conclusion, we believe strongly that neither proposal accomplishes the Commission's stated goal of enhancing customer protection. To the contrary, customers would be sending much larger amounts to their FCMs, leading to much greater volume of funds at risk if another MF Global situation occurs. If this rule had been in place when MF Global failed, perhaps twice as much customer money would have been missing and a correspondingly larger amount still would not be returned to customers.

Discussions with the Commission have not resolved these issues to date, and we continue to be mystified about how the meaning of the Commodity Exchange Act, interpreted consistently on this matter for decades, suddenly has changed. It is difficult to understand the reason for such a dramatic change in the CFTC's stance after decades of consistent interpretation. We continue to believe that the Act provides sufficient flexibility. However, if the Commission continues to contend that its hands are tied due to provisions of the Commodity Exchange Act, Congressional action may be needed to clarify the matter.

Reforms to the U.S. Bankruptcy Code

Nearly two years after the implosion of MF Global, companies and individuals that were customers of that FCM continue to deal with the aftermath of parent company MF Global

Holdings' bankruptcy and misuse of futures customer funds. Most U.S. futures customers so far have received distributions from the trustee of about 89% of their funds – funds that were supposed to have been segregated and protected. Recent developments have made it increasingly likely that the remaining 11% of customer funds will be returned to customers, but the NGFA believes strongly that statutory reforms are needed with the twin goals of preventing similar occurrences in the future and enhancing the rights and protections of futures customers in the event of a future FCM insolvency.

Among those changes, we believe that reforming the U.S. bankruptcy is the single most important step essential to preserving and codifying customers' rights and protecting customers' assets. To that end, the NGFA recommends the following statutory changes:

- The bankruptcy code should state clearly that customers always are first in line for distribution of funds, ahead of creditors, and that all proprietary assets including those of affiliates must go to customers first. This would provide clarity to regulators and to the courts in terms of prioritization of claims, an area in which precedent has not been established.

- Part 190 regulations of the CFTC should be incorporated into Subchapter IV of Chapter 7 of the bankruptcy code to harmonize the statutes and remove any interpretative inconsistencies. Generally, the bankruptcy code provides a limited description of the liquidation process of a commodity futures broker. The Commodity Exchange Act and bankruptcy regulations drafted by the CFTC provide much greater and more detailed guidance for the liquidation of a commodity broker or FCM.

- Under current bankruptcy law, powers of a trustee to recover customer funds are limited under so-called "safe harbor" provisions unless actual intent to defraud customers/creditors can be shown. The NGFA strongly recommends that any transaction involving the misappropriation of an FCM's customer property should not be protected under safe harbor provisions, regardless of the intent behind a fund transfer.

- To strengthen commodity customer protection, the CFTC should have a specifically identifiable role in the liquidation of an FCM. The CFTC should have the authority to appoint its own trustee to represent exclusively the interests of commodities customers. In a case like MF Global, in which over 95% of the assets and accounts affected were those of commodities customers, we believe the CFTC's authority should be strengthened and clarified.

- In the MF Global situation, creditor committees were established under the MF Global Holdings Chapter 7 proceeding, but there was no statutory provision under the SIPA liquidation of the MF Global Inc. for establishment of customer committees. The NGFA recommends that the bankruptcy code expressly should authorize the establishment of customer committees to represent FCM customer interests.

We are aware that other organizations also are working toward specific recommendations for changes in the bankruptcy code that will enhance customer protections. The NGFA intends to work cooperatively with such groups to develop consensus reforms that can be moved by Congress expeditiously.

Insurance or Liquidity Protection for Commodity Futures Customers – The NGFA recommends that insurance or insurance-like products should be available to commodity futures customers. Customers and their lenders who finance hedging in commodity markets must have confidence that their funds are safe and protected. We are aware that the Futures Industry Association and others currently are finalizing a comprehensive analysis of potential products and costs, and we consider it prudent to see that study before recommending a particular structure. We also are aware that the Commodity Customer Coalition recently has completed an online survey of commodity futures customers to gauge interest and input on insurance products. This data also could prove useful in crafting appropriate solutions.

Since the NGFA began working on potential customer protection enhancements early last year, we have been very mindful that most new customer protections will come at a cost – and that, eventually, the cost most likely will be borne by the customer. For that reason, we have taken a deliberate approach to recommending specific new protections, and we respectfully suggest that Congress and all stakeholders adopt a similarly cautious view. On the bright side, since the collapse of MF Global, significant new operational safeguards that should enhance the safety of customer funds have been put in place on commodity futures accounts by exchanges and regulators. These enhancements, already in place, should help mitigate costs of insurance or other customer protection efforts.

It is important to note that the solution on insurance to protect customers is not necessarily a government solution or a legislated solution. It may be that some form of privately provided product is more cost-effective and more appropriate. The NGFA has taken no formal view at this point on any specific structure. We advise strongly that data from the above-referenced efforts should be carefully considered prior to making such an important decision.

Fully Segregated Customer Accounts/Pilot Program – Currently, the Commodity Exchange Act and U.S. bankruptcy code provide for *pro rata* distribution of all customer property that was held by a failed futures commission merchant (FCM). Almost two years after the fact, former customers of MF Global have received back only 89% of their supposedly safe segregated funds through distributions from the trustee. This is unacceptable. Restoring the confidence not only of customers, but also of their lenders, is critically important. To that end, the NGFA has recommended establishment of an *optional* fully-segregated account structure to be offered and utilized by mutual agreement of customers and their FCMs.

Creation of a fully-segregated account structure necessarily would result in some additional costs that likely would be borne by customers that utilize such accounts. It is likely that some customers would opt for the added protections despite extra costs, while other customers might be unwilling or unable to bear those extra costs. For that reason, we propose that the full-segregation option be utilized on a voluntary basis at the agreement of an FCM and its individual customers.

We suggest that a pilot program involving a limited number of commodity futures customers, FCMs, and lenders, along with regulators, would be a useful means of testing the mechanics and identifying the viability and true costs of a full-segregation structure. It is our understanding that similar structures already are in place in the swaps marketplace, and perhaps that can offer insights into similar accounts for futures customers who may desire the same kind of protection. The NGFA does not recommend legislative action to establish a full-segregation account structure, but support for a pilot to test concepts would be constructive.

High Frequency Trading

Increasingly, traditional customers of agricultural futures markets are concerned about the impacts of high-frequency trading. Especially immediately preceding and following release of important crop and stocks reports by the U.S. Department of Agriculture, we believe high-frequency trading has caused and magnified volatile market swings. These disruptions have led many hedgers to avoid futures markets at such times, leading the NGFA to recommend a short pause in trading around releases of key USDA reports. Concerns also have been raised about the impact of high-frequency trading on order fills for traditional hedgers and about timely access to USDA reports, especially for those without mega-high speed connections.

It may be that regulatory action by the CFTC is the more appropriate way to address high-frequency trading issues. Should high-frequency traders be required to register with the Commission? Should such traders be required to post margin even if no positions are held at day's end? Are there other measures that should be considered to help ensure that high-frequency trading does not disrupt futures markets in ways that render them less useful to hedgers managing business risk? The NGFA suggests that these kinds of questions should be part of the conversation during reauthorization.

We look forward to working with the committee on these and other matters during the reauthorization process. Please do not hesitate to contact the NGFA with any questions.

Testimony of Dennis M. Kelleher
President and CEO
Better Markets, Inc.
"Reauthorization of the Commodities Futures Trading Commission"
Committee on Agriculture, Nutrition and Forestry
July 17, 2013

Good morning Chairman Stabenow, Ranking Member Cochran and members of the Committee on Agriculture, Nutrition, and Forestry ("Committee"). Thank you for the invitation to Better Markets to testify today on the important topic of the Commodity Futures Trading Commission ("CFTC") and Commodity Exchange Act ("CEA") reauthorization process ("Reauthorization").

Better Markets is a nonprofit, nonpartisan organization that promotes the public interest in the domestic and global capital and commodity markets. It advocates for transparency, oversight, and accountability with the goal of a stronger, safer financial system that is less prone to crisis and failure, thereby eliminating or minimizing the need for more taxpayer funded bailouts. Better Markets has filed more than 130 comment letters in the U.S. rulemaking process related to implementing the financial reform law and has had dozens of meetings with regulators. It also engages in public advocacy, independent research and litigation in the public interest. For example, we file Amicus briefs in support of the CFTC and other agencies when their rulemaking is challenged. Our website, www.bettermarkets.com, includes information on these and the many other activities of Better Markets.

My name is Dennis Kelleher and I am the President and CEO of Better Markets. Prior to starting Better Markets in October 2010, I held three senior staff positions in the Senate: Chief Counsel and Senior Leadership Advisor to the Chairman of the Democratic Policy Committee, Legislative Director to the Secretary of the Democratic Conference, and Deputy Staff Director and General Counsel to what is now known as the HELP Committee. Previously, I was a litigation partner at the law firm of Skadden, Arps, Slate, Meagher & Flom, where I specialized in securities and financial markets in the U.S. and Europe. Prior to obtaining degrees at Brandeis University and Harvard Law School, I enlisted in the U.S. Air Force while in high school and served four years active duty as a crash-rescue firefighter. I grew up in central Massachusetts.

INTRODUCTION

The role of the CFTC in today's U.S. and global derivatives and commodities markets is far greater than at any point in its history. Until the Dodd-Frank Consumer Protection and Wall Street Regulation Act ("Dodd-Frank") was passed in July 2010, the CFTC's jurisdiction was limited to the US futures markets, which had $37 trillion in notional value in 2012 with over 7 billion trades taking place.[1] The worst financial crash since 1929 and the worst economic crisis since the Great Depression changed all that and responsibility for regulating the $340 trillion US swaps markets was added to the

1 http://www.futuresindustry.org/volume-.asp

CFTC's mandate. As is widely known, this was necessary because the global financial crisis of 2008 was largely incubated in and triggered by dark, unregulated derivatives markets, and the Dodd-Frank Act amended the CEA to require the CFTC to regulate those markets and require transparency and prudent risk management so that such a calamity never happens again to the American people.

Given how extensive, indeed, historic these changes are, the Committee should consider renaming the CFTC as the "Commodities Futures and Swaps Trading Commission" ("CFSTC") so that its name more accurately reflects the breadth and depth of its jurisdiction and mission. After all, its jurisdiction has increased more than six times and has been extended to entirely new markets and products.

The financial reform law marked a vital, momentous and long-overdue modernization of the CEA. While these changes are critical for well-functioning markets, systemic stability, investor protection and avoiding more massive taxpayer bailouts in the future, they have not been welcomed by all. In particular, the sell-side of the industry, the derivatives dealer oligopoly, their trade groups and other allies, have relentlessly attacked the new provisions and the CFTC, trying to gut or weaken many of the provisions. This is only natural and to be expected because they were able to extract hundreds of billions of dollars in excess profits from non-transparent, unregulated derivatives trading because they had an unfair competitive advantage and an un-level playing field.

While that was great for the businesses, profits and bonuses of Wall Street, it was a nightmare for Main Street that had to pay the bill for the derivatives dealers reckless trading and investments. (The 2008-2009 financial crises are expected to cost the U.S. more than $12.8 trillion, as discussed below.) The financial reform law generally and the modifications to the CEA in particular are designed to change that, especially by requiring transparency and competition, both killers of Wall Street's excess derivatives profits.

Thus, it is no surprise that various industry participants – often pretending as though no financial crisis ever occurred or that derivatives had little to do with it – have pushed non-stop since its passage to repeal, water down and otherwise weaken the essential transformative changes to the CEA. Unfortunately, the present CFTC reauthorization process represents only the latest opportunity for the derivatives dealers club to attempt to weaken these vital legal protections for the US taxpayer and financial system. Stripped of their soothing sounding claims and ostensible concerns, the changes sought would risk – or result in – a return to the "wild west" of over-the-counter derivatives dealing that brought on the last crisis and assuredly will bring on the next one.

We would urge the Committee to reject pleas to reopen and re-litigate the financial reform law. Not only because there is little if any merit to doing so, but also because it has not even been put in place yet. Indeed, virtually all of the complaints about the law are entirely speculative for that very reason.

The law and its implementing regulations must be allowed to be put in place before changes are made to what is still very much a work in progress. Yes, changes in the future might be necessary and there might be unintended consequences that were not foreseen when the law was passed, but to make those changes now would be, at best, premature.

Moreover, suggestions that the CFTC should slow down, if not stop, its impressive efforts to implement financial reform should also be rejected. It is now five years since the financial crisis and three years since the financial reform law was passed, but much of financial reform is not yet in place, largely due to massive and unprecedented industry opposition. The CFTC is required by law to put the reforms in place and has taken this responsibility seriously. It should be praised, not punished, criticized, slowed down or stopped. In particular, the CFTC should not be held hostage to any other agency, not the SEC, international regulators or anyone else. Of course, the CFTC should work with and coordinate with fellow regulators and it has, to an unprecedented degree, but the requests for "coordination" and "harmonization" amount to little more than requests to subordinate the CFTC to other regulators. Worse, it is the substantive equivalent of regulator and rule shopping. That too must be rejected.

Notwithstanding what can only be described as a relentless, multi-front war on the agency, the CFTC has done an outstanding job in transforming the financial reform law into a derivatives market reality (even though we have often not agreed with particular provisions of certain rules). History will look back and laud its singular accomplishments. The CFTC is to be commended for this. However, it has been a struggle and, too often, needlessly so, mostly due to inadequate resources, which has deprived it of enough personnel and technology to do the job the law requires of it. Without a greatly increased budget and stable funding source, the CFTC will simply not be able to continue to implement the law, oversee these vital markets, ensure financial reform is a durable reality, and protect the American people from another derivatives-fueled crash.

There are other areas of great importance that this Committee should consider in connection with CEA reauthorization. In particular, as remarkable as it is, there are still high risk areas of the derivatives markets that remain, if not dark, with insufficient transparency, data and oversight. There are also areas that the Dodd-Frank law did not adequately cover and certain omissions that were not foreseen. We highlight some of those areas below and offer suggestions as to how this Committee might consider approaching them from a legislative perspective. In addition, there are areas in which the CFTC already has adequate authority, yet has failed to exercise it. Here, too, I offer suggestions as to how the Committee might act to address these issues through its overall supervisory role.

Importantly, the suggestions below are not intended to reopen or re-litigate the Dodd-Frank law, which we believe would be a grave mistake and a gross disservice to the American people. Rather, they are intended supplement the existing statutory framework to make it more effective as it pertains to the CEA. Broadly speaking, the comments will cover several key areas: funding, data, and other necessary augmentations and clarifications to the CFTC's mandate (or execution of that mandate) including high frequency trading, commodity index funds, physical commodity holdings, position limits and the SRO model. Finally, I will discuss why the CFTC's existing economic analysis requirement is appropriate, serves the public interest and should not be changed.

FUNDING

The CFTC is in charge of ensuring the transparency, stability, fairness, and integrity of 97.5 percent of the $340 trillion dark derivatives market in the United States.[2] 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, with projected total costs to the US economy of $12.8 trillion. That is what gave rise to the financial reform law in general and derivatives reforms in particular.

The Commission has been diligently and expeditiously working towards finalizing the congressionally mandated rulemaking process to bring the Dodd-Frank derivatives reforms to life. As of July 12, 2013, the Commission has proposed 67 rules and finalized 46 of them.[3] In addition, just last Friday, it adopted cross-border interpretive guidance that is intended to regulate cross border swaps activities with a "direct and significant" impact on United States commerce. 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.[4] Moreover, the Commission has received and reviewed more than 39,000 comment letters on matters related to derivatives 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. However, the CFTC is far ahead of the other agencies despite facing significant obstacles, including limited personnel and funding. While CFTC funding is in the jurisdiction of the Appropriations Committee, this Committee should do

---

2 CFTC vs. SEC jurisdiction calculated from data presented in Bank for International Settlements, *Annual derivatives market report 2012* and corroborated using DTCC and CFTC data.

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

4 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

everything in its power to ensure a stable and adequate level of funding for the CFTC going forward so that it can effectively fulfill its crucial duties in the derivatives markets.

CFTC Cannot Carry Out Its New Responsibilities Without Sufficient Funding

The CFTC's entire budget for 2012, totaling $206 million, was less than half the $574 million dished out in compensation in 2007 to the top executives at the nine banks who received the first round of TARP funds.[5] Even the modestly expanded $315 million budget requested in the President's budget would still be less than half as large as the $647 million in fees that JP Morgan demanded in just one derivatives deal: Jefferson County before that municipality went bankrupt due to abusive derivatives entered into in connection with debt offerings.[6] In light of the importance of their vastly expanded responsibilities, the CFTC's funding requirements are reasonable, necessary and urgent.

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

On September 15, 2012, Better Markets issued a report on 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.[7] 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.[8]

In the context of a $12.8 trillion cost to the United States, increasing the starved CFTC budget to the approximately $300 million level requested simply has to be a priority for anyone serious about financial reform.[9] This funding will enable the CFTC to increase its personnel and technology modestly, and to the extent the Committee can facilitate that, it will be a worthwhile and necessary first step.

However, a CFTC entirely dependent on annual appropriations is an agency at risk of chronic underfunding. Moreover, requiring the CFTC to compete with so many other funding priorities is irresponsible given that the CFTC has a funding stream available to it. The Committee should consider authorizing self-funding of the CFTC 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. Indeed, given the large size of the futures and swaps

---

5 http://money.cnn.com/news/specials/storysupplement/ceopay/

6 http://blogs.wsj.com/moneybeat/2013/06/05/how-much-did-jefferson-county-cost-j-p-morgan/

7 *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.

8 *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.

9 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.

markets, and the relatively small budget requested by the CFTC, a transaction fee much lower than that assessed by the SEC would suffice to fully fund the CFTC.

Unless the regulators have the resources to do their job, the American taxpayer will remain at risk of another crisis, and the markets will remain plagued by thousands of smaller inefficiencies and abuses that may not be systemically risky but which nevertheless represent a drain on the US economy by diverting resources away from their most productive use.

Staffing and Technology: Two Necessary Areas of Improvement

There is no genuine debate that the CFTC is woefully underfunded, understaffed and grossly lacking in technology. From 1999 to 2007, the agency shrunk from 567 full-time equivalents ("FTEs") to 437. Currently, the CFTC has 690 FTEs which is less than 10 percent more than at the peak in the 1990s.[10] 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.[11] 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.[12] 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.

That the CFTC has to struggle for funding is particularly indefensible given that the civil penalties assessed by the CFTC against financial market participants who violate the CEA far exceed the CFTC budget. Last year, for instance, the CFTC assessed civil penalties of $416 million, over double its budget.[13] These penalties flow into the United States Treasury, making the CFTC a profit center for the government. The CFTC thus represents an excellent investment for US taxpayers – both protecting them against having to fund another bailout, and also clawing back funds from firms that break the law – often the very same institutions that were previously bailed out.

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

[10] 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.

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

[12] 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.

[13] http://www.cftc.gov/PressRoom/PressReleases/pr6378-12.

due to limited resources and additional responsibilities.[14] 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.

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" debacle[15] would currently go undetected, since "none of our computer programs load [Swap Data Repository] data without crashing."[16] According to Commissioner O'Malia, the current CFTC budget allows for only about $12 million for actual technology investment.[17] To put this in perspective, that is about as much as what a dozen or so large high frequency traders might pay for a year's worth of colocation fees at the CME and NYMEX.

This comparison is particularly apt since it is precisely the rising tendency of exchanges to sell or allow lucrative privileged data feeds to powerful market participants that has made technology so central to the modern markets. This speed war has encouraged a proliferation of algorithmic trading and High Frequency Trading ("HFT") in derivatives markets.[18]

Yet at the same time, this problem perhaps holds the seeds of its own solution. 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, which is essential for even minimal oversight.

But technology is useless without the right staff to utilize it, and it must not be used as a pretext to divert funds from crucial personnel. Without qualified and experienced staff, the CFTC will not be able to effectively and efficiently regulate, even with the best technology in the world. In short, the CFTC needs technology and people and one must not be allowed to cannibalize the other.

---

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

15 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.

16 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.

17 http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-23

18 *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 .

To address the agency's grossly underfunded budget, the President requested $308 million and 1,015 FTEs for the fiscal year 2013.[19] 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. Unfortunately, some on Wall Street appear to want the CFTC underfunded because it is 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.

The CFTC's budget request of $315 million is insignificant in comparison to the roughly $37 trillion U.S. futures market and $340 trillion U.S. swaps market they are tasked with supervising. A fee sufficient to fund the agency at a level that would match their needs would hardly be noticeable by market participants, and would be considerably smaller than the SEC's Section 31 fees. The President has recommended such a step, the markets can clearly sustain it, and Better Markets fully supports it. All of the banking agencies are self-funded, as is the Consumer Financial Protection Bureau. The Committee should work to devise a fee-based funding arrangement that would enable the CFTC to catch up and then keep up with the vast growth of the markets it must regulate.

DATA

Despite the Dodd-Frank Act's drive toward transparency, 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

[19] 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.

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.

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 identified and 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 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.[21] The CFTC already has authority to regulate these entities and to impose position limits on them as it deems appropriate. However, so that the existing authority is even more clear, the Committee 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. This would clarify the CFTC's authority to restrict such trading or to attach conditions to it (including public disclosure obligations of the type required under securities laws for exchange-traded commodity funds[22]),

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.[23]

---

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 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 percent of the time and (2) that 90 percent 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.

22 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.

23 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

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.[24] The reported levels of ownership – with a single bank in some cases owning 25 percent of deliverable supply – are a clear threat to the orderly functioning of commodities markets.[25] 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.[26] This dramatic change requires data gathering, review, and, where appropriate, regulation.

It is no secret that banks and other institutions have been trading physical commodities for some years. The Wall Street Journal reported as early as June 2006 that "Dominant commodity traders such as Morgan Stanley and Goldman Sachs Group Inc. long have had strategies to own or lease fuel-storage terminals, oil tankers and power plants...[and] recently, those Wall Street firms have taken physical trading to new levels with bids to buy, not lease, distribution facilities such as pipelines and production facilities including refineries. Hedge funds also have gotten into the game of dealing in physical energy and even metals assets. "[27]

In 2008, JP Morgan joined the physical oil trade,[28] and it has been rumored that Morgan Stanley is the single largest physical jet fuel dealer in the United States.[29] In light of the ongoing manipulation cases in both financial indices[30] and commodity indices,[31] it is clear that improved scrutiny of these physical trading operations is both necessary and urgent.

---

actively-managed commodity funds that would provide genuine liquidity to *bona fide* hedgers, in contrast to commodity index funds which absorb liquidity.

24 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.

25 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.

26 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.Sil8Bm8M.

27 Ann Davis, "Case Raises a Tough Query: When Do Traders Cross Line?" Wall Street Journal, June 30th 2006 available at http://online.wsj.com/article/SB115163341075595034.html

28 "JPMorgan to start physical oil trade, eyes $200 oil" Reuters, 15 May 2008

29 *See*, e.g. http://finance.fortune.cnn.com/2012/04/12/delta-oil-refinery/

30 http://www.guardian.co.uk/business/2013/jul/15/sfo-charges-two-brokers-libor

31 http://www.bloomberg.com/news/2013-07-15/u-k-regulators-consider-criminal-probe-into-oil-price-fixing.html

High Frequency Trading

HFT[32] is another new threat to the marketplace that could not have been foreseen by previous drafters of the CEA. New loopholes have been created, and are now being exploited, to the detriment of commodity market participants and, ultimately, the consumers they are meant to serve.[33] Indeed, we view HFT as one of the most important issues facing the U.S. markets today, especially as the new emerging derivatives markets infrastructure is being put in place as required by the Dodd-Frank Act.

Unfortunately, we are all too familiar with the many breakdowns, crashes, and debacles, often with very substantial investor losses, that have been caused by or associated with HFT:

- The Flash Crash in May 2010 was set off by a single large trade estimated at $4.1 billion in the S&P 500 E-Mini Futures Market. The cascade led to 20 minutes of extreme volatility, wiping out nearly $1 trillion of market cap before quickly and inexplicably recovering. The total economic cost of this event is unmeasured, but certainly huge. We were lucky it didn't happen near the market close – had the U.S. market closed before it recovered, the result could have been total economic disaster because money would have hemorrhaged out of the stock market overnight. In addition to the economic cost, the real cost of the flash crash was a loss of investor confidence.

- In August, 2011 the stock market swung up and down by over 4.4 percent on four consecutive days, alternating up and down days. It was wild, unprecedented volatility – only the third time in history that had happened, with the second time having been three years prior, during the crash of 2008. While the European crisis was becoming a more important issue at the time, this volatility was not warranted by major economic changes or historic macroeconomic events. This was computer-driven volatility.

- "Mini flash crashes" occur on a near-daily basis in individual stocks. Nanex has documented almost 2,000 instances of individual irregularities in stocks since August 2011.[34] Single-stock circuit breakers have failed to stem the tide of these incidents.

- IPO's in Facebook and BATS (itself an exchange) have gone horribly wrong due to technological fiascos, continuing to sour the already languid market for IPO's and

---

32 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 percent 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.

33 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.

34 http://www.nanex.net/aqck/aqckIndex.html.

costing untold numbers of jobs as companies cannot raise the capital they need to expand and hire.

- Few realize how lucky we were on Tuesday, July 30, 2012. An order to sell nearly $4.1 billion in the S&P 500 E-Mini Futures Market, the same size as what precipitated the Flash Crash, was executed three seconds before the market closed. There simply was not enough time for the waterfall of May 6, 2010 to repeat itself. What happens the next time when that same order is sent in a couple of minutes sooner? This quote from the Joint SEC/CFTC Flash Crash report should be a cause of concern for all: *"Indeed, even in the absence of extraordinary market events, limit order books can quickly empty and prices can crash simply due to the speed and numbers of orders flowing into the market and due to the ability to instantly cancel orders."*[35]

- On Wednesday, July 31, 2012, Knight Capital Group – one of the largest market making firms, an official Designated Market Maker on the NYSE, had a software breakdown according to their CEO. The result? A loss for them estimated at $440 million, untold economic losses for retail investors with stop-loss orders in one of the almost 140 stocks that were affected and further erosion in investor confidence.

- In April of this year, high speed algorithmic trading was implicated in the 145-point market sell-off triggered by a fake post on the Associated Press Twitter feed.

- In May, the *Wall Street Journal* revealed that HFTs were essentially front-running other customers on the CME and thereby distorting prices. The article also cited a study by the Tabb Group which found HFT now comprises "about 61 percent of all futures market volume, up from 47 percent in 2008."[36]

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?" On that occasion, I 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.

---

[35] Summary Report of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues, Feb. 18, 2011

[36] Jenny Strasburg, "A Wild Ride to Profits", Wall Street Journal, August 16 2011, available at http://online.wsj.com/article/SB10001424053111904253204576510371408072058.html

"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 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."[37]

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.[38] As with commodity index funds, mandatory registration of all commodity HFTs with the CFTC is an essential first step. It is simply unacceptable that the CFTC should lack this crucial regulatory tool with respect to traders who possess the capacity to wipe out huge swathes of commodity markets in minutes just as they temporarily erased nearly one trillion dollars of stock market wealth during the flash crash. Many market participants have already complained that the markets are no longer effective as hedging instruments. How much more so if genuine commercial participants are driven to flee the markets by a flash-crash like scenario in commodity contracts?

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, among other things, an over-reliance on special interest groups from the financial industry. For example, the CFTC definition failed to include any language on holding periods or inventory. This essentially had the effect of casting a very broad net with their definition. In fact, most institutional investors, even plain vanilla mutual funds, would be considered high frequency traders under the proposed definition.

Moreover, there are clear abuses relating to HFT, but very few enforcement cases. For example, the NYSE was fined $5 million by the SEC for sending data to HFTs through its proprietary feeds before sending it to the consolidated feed. This confirmed the fears frequently expressed by institutional and retail investors that they are facing a rigged stock market. The recent Thompson Reuters case, in which the New York Attorney General ordered the company to suspend its program under which it sells market-moving data 2 seconds earlier to premium subscribers, is another indication that market

---

[37] 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-.

[38] 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.

participants today are not operating on a level playing field.[39] Price discovery is premised on sound information flows, and the HFT-driven culture of collocation, structural trading advantages and asymmetric information advantages for the fastest computerized trader is a dangerous threat to this cornerstone of the commodity markets.

FIVE FURTHER CRITICAL ISSUES TO CONSIDER

Beyond the above suggestions, there are five 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 levels than currently to ensure that those penalties serve the critically important purposes of punishment and deterrence.

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 a very important change, as it would enable the CFTC to impose more appropriate penalties not just for manipulation but for other violations of the CEA.[40] Currently, the maximum penalty for violations that do not constitute manipulation are considerably lower than for those that do.[41] 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.

This issue has also been highlighted by several other parties, including CFTC Commissioner Bart Chilton,[42] the National Farmers Union, and The Commodity Markets Oversight Coalition representing end-users.[43] We urge the Committee to seriously consider it because without suitable deterrents industry participants will lack

---

39 http://www.bloomberg.com/news/2013-07-08/selling-a-sneak-peak-at-consumer-data-is-good-business-.html
40 17 CFR 143.8.
41 *Id.*
42 http://www.cftc.gov/PressRoom/SpeechesTestimony/opachilton-91
43 NFU and CMOC letters to the Committee on the topic of CFTC reauthorization.

sufficiently strong incentives to abide by CFTC regulations, with the whole market suffering as a result.

Absolute Limits on Financial Speculation in Commodities

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. Yet the CFTC rule on position limits that was vacated by the Federal District Court (on procedural grounds and did not reach the merits) did not address the aggregate level of speculation in the market. 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, in the aggregate, to 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, at a minimum, 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.

While the financial industry and the exchanges are adamantly opposed to such limits – naturally, since they have the perverse incentive to maximize profits by maximizing speculation – the end-user community on the whole feels very differently.[44] Given that the CEA defines end-users as the "primary constituency" of the commodities markets, the Committee should see to it that their interests are not sacrificed to promote those of the financial industry simply because the latter are able to lobby loudly, engage in lengthy, costly legal battles over rulemakings, and gain the support of the exchanges by providing vast volume that purports to improve liquidity but really just increases volatility and therefore costs for actual producers and consumers.[45]

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

---

[44] For a small sample of complaints from end users, *see* http://www.reuters.com/article/2012/02/01/us-metals-jpmorgan-idUSTRE81019I20120201, http://www.ft.com/intl/cms/s/0/fa802828-94af-11df-b90e-00144feab49a.html#axzz2Z9J07jpd and http://www.iatp.org/documents/october-18-letter-from-cmoc-to-cftc-concerning-speculative-position-limits

[45] http://www.princeton.edu/~wxiong/papers/commodity.pdf

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 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.[46] 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.

Against this background, it is clear that all calls for a statutory definition of *bona fide hedging* must be carefully weighed.[47] There are companies that would gladly have the definition of a *bona fide* hedge expanded beyond all reasonable limits to include any activity – including speculation – carried out by a company trading physical commodities. Such an approach would have deeply damaging effects on the markets, essentially allowing energy and other commodity traders to set up huge, unregulated hedge funds within their corporate shield. For this reason, any attempt to set a statutory definition of *bona fide* hedging must be painstakingly developed to ensure that it is not overly broad.

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.[48] 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 "re-

---

[46] PSI Report, at 103.

[47] See, for example, letters from FIA and API

[48] 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/.

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 "re-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.[49] 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. While there is nothing wrong with "re-futurization" *per se*, the opaque manner in which it has been effectuated is deeply problematic, done to further narrow self-interest, and improperly opens arbitrage opportunities.

Dodd-Frank was designed to bring futures-like transparency to swaps, not OTC-like opacity to DCMs.

The decision to do this was enabled by ICE's privileged "self-regulating" status. 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

---

[49] www.theice.com

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.

Cost-Benefit Analysis

The CEA already requires the CFTC to conduct an appropriate amount of economic analysis when it promulgates rules so that markets, investors and taxpayers are properly protected.

While some have argued that the CFTC should be required to conduct an onerous cost-benefit analysis for every rule it promulgates, the Committee should firmly reject any such amendments to the CEA. It is noteworthy that the CFTC has done its analysis well for decades, but only now its analysis is under near-constant attack. This should be seen for what it is: yet another backdoor attempt to kill, gut, weaken, or frustrate financial reform.

When analyzing any attempt to increase the CFTC's economic analysis burden beyond what the agency already must shoulder, it is vitally important to remember the following core facts and principles:

(1) the CFTC already has a significant obligation to consider costs and benefits when it promulgates rules, in light of five factors enumerated in the CEA;

(2) over many years, the agency has successfully fulfilled that obligation while writing hundreds of rules, carefully protecting market participants and the public while enabling the futures markets to thrive; and

(3) imposing yet more obligations on the CFTC such as what is commonly referred to as "cost-benefit analysis" (but which is really "industry cost-only analysis") would greatly reduce its ability to protect the American people and the markets from excessive risk and another financial crisis as well as to carry out its regulatory mission and fulfill Congress's policy objectives.

1. *Under the CEA, the CFTC already has an obligation to consider costs and benefits, and for good reason, Congress deliberatley chose not to impose a duty to conduct cost-benefit analsyis.*

Under Section 15(a) of the CEA, the CFTC already has a clear statutory obligation to "consider" the costs and benefits of its discretionary actions as they relate to certain public interest factors.[50] Specifically Section 15(a) directs the agency, when promulgating a rule, to "consider the costs and benefits of the action of the Commission" and to evaluate those costs and benefits "in light of"—

(A) considerations of protection of market participants and the public;

(B) considerations of the efficiency, competitiveness, and financial integrity of futures markets;

(C) considerations of price discovery;

(D) considerations of sound risk management practices; and

(E) other public interest considerations. [51]

Congress's careful choice of words in Section 15(a) makes clear that Congress intended the CFTC to have broad discretion in discharging its duty.[52] In fact, unlike in many other statutes, Congress chose ***not*** to require the CFTC to quantify costs or benefits,[53] weigh them against each other,[54] or find that a rule will confer a net benefit before promulgating it.

---

[50] 7 U.S.C. § 19(a).

[51] 7 U.S.C. § 19(a).

[52] Better Markets has set forth a comprehensive analysis regarding the scope of Section 15(a) in the *amicus curiae* brief it filed in support of the CFTC in *ISDA v. CFTC,* Civil Action No. 11-cv-2146 (RLW) ("*Amicus* Brief") (*available at* http://bettermarkets.com/sites/default/files/Corrected%20Brief%20of%20Better%20Markets%20as%20Amicus%20Curiae%20in%20Support%20of%20Defendant%20CFTC%20Apr.%2030,%202012.pdf). In that case, representatives of industry challenged, *inter alia*, the CFTC's consideration of costs and benefits in connection with the position limits rule. *See also* Better Markets *amicus* Brief filed in another case challenging a different rule, *available at* http://bettermarkets.com/sites/default/files/ICI%20v.%20CFTC%20-%20Amicus%20Brief%20of%20Better%20Markets%20June%2025,%202012.pdf. In addition, Better Markets has written to the Office of Management and Budget ("OMB") opposing CFTC Commissioner Scott O'Malia's request that OMB review the cost-benefit analysis performed by the CFTC in connection with several recently finalized rules. Letter from Better Markets to Jeffrey Zients, Acting Director of OMB (Feb. 29, 2012) ("Letter to OMB"), *available at* http://bettermarkets.com/sites/default/files/O'Malia%20CBA%20letter%20to%20OMB.pdf. In the Letter to OMB, Better Markets makes clear that various executive orders and OMB guidelines requiring cost-benefit analysis are inapplicable to the CFTC's rulemaking.

[53] *Cf.* 42 U.S.C. § 300g-1(b)(3) (imposing a duty on the Environmental Protection Agency to use analysis of specific factors including the "[q]uantifiable and nonquantifiable health risk reduction benefits," the "[q]uantifiable and nonquantifiable costs," and "[t]he incremental costs and benefits associated with each alternative."). Courts have repeatedly held that an agency need not quantify the costs and benefits of a rule when a statute does not require it. *See, e.g., FMC Corp. v. Train*, 539 F.2d 973, 978-979 (4th Cir. 1976) (finding that 33 U.S.C. §§ 1314(b)(1)(B), (b)(2)(B) and § 1316 do not require quantification of the benefits in monetary terms). In fact, the D.C. Circuit has explicitly recognized that an agency's "predictions or conclusions" do not necessarily need to be "based on a rigorous,

As discussed further below, the rationale for this flexible obligation in the law is clear: requiring the CFTC to conduct a resource intensive, time consuming, and inevitably imprecise cost-benefit analysis as a precondition to rulemaking would significantly impair the agency's ability to implement Congress's regulatory objectives. Moreover, the industry's desire to have its costs prioritized over all other costs (what they falsely refer to as "cost-benefit analysis") is not a legitimate reason to change the law.

2. *The CFTC has faithfully adhered to its statutory obligation, and in so doing, has effectively regulated the futures markets while allowing them to flourish.*

For years, the CFTC has adhered to the statutory standard in Section 15(a). The discretion afforded to the CFTC under that provision has allowed the agency the necessary leeway to promulgate ***effective*** regulations in an efficient manner, all without imposing undue burdens on the markets or market participants.[55] Indeed, the United States Court of Appeals for the District of Columbia Circuit recently confirmed that the CFTC's economic analysis obligation is limited, and that the agency has appropriately discharged its duty.

In *Inv. Co. Inst. v. CFTC,* [56] the plaintiffs challenged the CFTC's recently-adopted rule requiring registered investment companies trading in commodity interests (including swaps) to register with the CFTC as commodity pool operators. Among the plaintiffs' core arguments was that the CFTC had failed to conduct an adequate "cost-benefit analysis" when it promulgated the rule. The Court rejected this claim, holding that the agency's consideration of costs and benefits under the five statutory factors was adequate.[57] Furthermore, the Court made very clear that the CFTC's duty under Section 15(a) is fundamentally different from a quantitative cost-benefit analysis:

---

quantitative economic analysis." *Am. Fin. Services Ass'n. v. FTC,* 767 F.2d 957, 986 (D.C. Cir. 1985); *see also Pennsylvania Funeral Directors Ass'n v. FTC,* 41 F.3d 81, 91 (3d Cir. 1994) (recognizing that "much of a cost-benefit analysis requires predictions and speculation, in any context," and holding that the "absence of quantitative data is not fatal").

54 Courts distinguish statutes which include language of comparison, requiring a cost-benefit analysis, and statutes which do not. *See Am. Textile Mfrs. Inst. v. Donovan,* 452 U.S. 490, 512 n.30 (1981); *Reynolds Metal Co. v. EPA,* 760 F.2d 549, 565 (4th Cir. 1985); *Weyerhaeuser Co. v. Costle,* 590 F.2d 1011, 1045 (D.C. Cir. 1978).

55 "The CFTC regulates a futures and options industry that increased from 250 million contracts in 2001to more than 2.5 billion contracts in 2011. The value of customer funds held in Futures Commission Merchants Accounts, during the same period, increased from $56.7 billion to more than $203.7 billion, and the value of these contracts is notionally estimated at $40 trillion. With the passage of the Dodd-Frank Act, the CFTC is tasked with regulating the swaps markets with an estimated notional value of approximately $300 trillion – roughly eight times the size of the regulated futures markets." CFTC, *President's Budget and Performance Plan: Fiscal Year 2013,* at 1 (Feb. 2012), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2013.pdf.

56 *Inv. Co. Inst. v. CFTC,* No. 1:12-cv-00612 (D.C. Cir. June 25, 2013)

57 *Id.* at 13.

> The appellants further complain that CFTC failed to put a precise number on the benefit of data collection in preventing future financial crises. But the law does not require agencies to measure the immeasurable. CFTC's discussion of unquantifiable benefits fulfills its statutory obligation to consider and evaluate potential costs and benefits . . . . Where Congress has required "rigorous, quantitative economic analysis," it has made that requirement clear in the agency's statute, but it imposed no such requirement here.[58]

3. *Imposing a cost-benefit obligation on the CFTC would create an enormous obstacle to strong and timely rulemaking that protects the public interest.*

First, and foremost, requiring the CFTC to conduct cost-benefit analysis would directly interfere with the implementation of Congress's regulatory priorities. The point is obvious and irrefutable with respect to any rulemaking that Congress has mandated. Not only is it unnecessary under the statute for the CFTC to consider the costs and benefits of actions mandated by Congress, it would also be fruitless to require the agency to do so, since the agency has no authority to second-guess, ignore, or countermand the directives of Congress on cost-benefit or any other grounds.

Indeed, by mandating a rulemaking, Congress necessarily has already weighed the costs and benefits, and the agency's role is simply to implement Congress's directive. To construe a statute otherwise would make it impossible for Congress to mandate a rulemaking because all such rules would nonetheless be subject to some form of economic or cost-benefit analysis by an agency and, almost assuredly, by a court. That would violate the constitutional principles of separation of powers, subordinating Congress's legal powers to both the agencies and the courts.

Even as to the discretionary components of a congressional directive or grant of rulemaking authority, imposing a cost-benefit analysis standard would be extremely unwise. It would severely drain the CFTC's resources, delay its rulemaking process, and ultimately weaken the agency's ability to protect the public interest. In reality, cost-benefit analysis is an imprecise process, particularly in the field of financial regulation. While industry can identify and quantify the ***costs*** of regulation with relative ease, the task of measuring the **benefits** of regulation is much harder—even though the benefits may be enormous. Faced with such challenges, the CFTC would be forced to dedicate many more resources to the effort, and it could be expected to delay or even weaken many of its proposed rules based on stringent cost-benefit standards—not because the rules are unworthy or unnecessary, but because they cannot pass muster under the inherently imprecise cost-benefit test.

There can be no doubt that anyone seeking to thwart effective regulation of our commodities markets would eagerly and frequently invoke a cost-benefit analysis obligation in an effort to attack and invalidate rules as they are adopted by the CFTC. One need only look at the way opponents of financial reform have attempted to use

---

[58] *Id.* at 14-15 (cited authorities omitted).

Section 15(a), with its very limited economic analysis obligation, to attack rules. Indeed, even when the CFTC has clearly fulfilled its duty to consider the economic impact of its rules, industry representatives have challenged those rules claiming – without merit – that the CFTC failed to appropriately conduct what the industry calls "cost-benefit analysis." These attacks rest on a series of fundamentally flawed claims. For example, in challenging rules promulgated by the CFTC, the industry has:

(1) greatly exaggerated the actual duty imposed on the CFTC by its governing statute, Section 15(a) of the CEA, in effect seeking to transform that limited duty into an "industry cost-only analysis;"

(2) entirely disregarded the paramount statutorily required role of the public interest in the rulemaking process; and

(3) indefensibly ignored the enormous cost of the 2008 financial crisis and the larger collective benefit of all rules designed to help prevent a recurrence of that crisis or something far worse.

In reality, imposing cost-benefit analysis on the CFTC would be highly detrimental, all for no legitimate purpose. Simply put, there is no reason to prioritize minimizing cost to industry over the protection of the public interest in the commodities markets.

Indeed, when Congress drafted Section 15(a), it clearly intended to put the public interest ahead of all other concerns. The five factors that the CFTC must consider as specified in Section 15(a) reflect Congress's primary concern with the need for regulations that serve the public interest and accomplish the agency's mission, not with a need to spare industry the costs of regulation.

Without exception, each factor relates to a public benefit that arises from a robustly regulated marketplace, including preventing abuse, promoting competition, enhancing transparency, and limiting systemic risk.[59] Tellingly, none of the factors listed in the statute mentions any industry-focused concerns, such as compliance costs or the feasibility of conforming to rule requirements.[60] Removing any doubt, the fifth and final factor in Section 15(a) requires the CFTC to consider generally "any **other public interest** considerations."[61]

Finally, imposing a strict cost-benefit standard on the CFTC would prevent it from advancing the single most important "public interest consideration," which is completing the collection of reforms that Congress passed to provide for a safer and sounder

---

59 7 U.S.C. § 19(a)(2).

60 *Cf.* 42 U.S.C. § 300g-1(b)(3)(C) (requiring analysis of certain costs of safe drinking water regulations including costs that "are likely to occur solely as a result of compliance with the maximum contaminant level, including monitoring, treatment, and other costs"); 42 U.S.C. § 6295(d) (1976 ed., Supp. II) (requiring a weighing of the economic impact on manufacturers and the savings in operating costs as "compared to any increase in the price of, or in the initial charges for, or maintenance expenses of, the covered products which are likely to result").

61 7 U.S.C. § 19(a)(2)(E) (emphasis added).

financial system and to prevent another financial crisis. The CFTC must consider the costs and benefits of any proposed rule implementing financial reform in light of the overarching goals of the Dodd-Frank Act. Those goals include preventing another financial collapse and economic crisis, including trillions of dollars in financial losses and incalculable human suffering.

The dollar cost alone of the financial collapse and still-unfolding economic crisis is conservatively estimated to be in the trillions. A study by Better Markets estimates that those costs will exceed $12.8 trillion. [62] In addition, the Government Accountability Office recently issued the results of a study on the costs of the crisis, finding that "the present value of cumulative output losses [from the crisis] could exceed $13 trillion."[63] Therefore, as the CFTC assesses the costs and benefits of proposed rules under Section 15(a), it must continue to consider, above all, the benefits of the entire collection of reforms embodied in the Dodd-Frank Act, of which any specific rule is but a single, integral part. The rigid, narrow, and quantitative requirements of cost-benefit analysis preclude this all-important holistic approach to rulemaking.

Congress passed the Dodd-Frank Act knowing full well that it would impose significant costs on industry, yet it determined those costs were not only justified but necessary to stabilize our financial system and avoid another financial crisis. Those costs include the elimination of extremely profitable lines of business as well as significant and ongoing compliance costs. A leading example is the establishment of the new, comprehensive regulatory regime for swaps. It will require the financial industry to incur significant costs arising from new personnel and technology, ongoing compliance, margin and collateral, and reduced revenues and profits.

However, the financial reform law and the rules implementing it do not, in fact, add any incremental costs (or, if they do, those costs are *de minimis*). Rather, they reallocate costs so that industry bears them in a regulated environment that **prevents** financial failure and bailouts. As a result, the public and society are spared the massive costs of responding to economic crises after the fact.[64]

Congress fully understood this. It knew that re-regulation would impose costs on the industry, in some cases totaling billions of dollars. The Dodd-Frank Act reflects Congress's unflinching determination to shift the costs of de-regulation and non-regulation of the financial industry back to the industry from a society that has paid and continues to pay the bill for industry's unregulated excesses. In substance, Congress conducted its own cost-benefit analysis and concluded that the enormous collective

---

[62] *See* BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis.pdf.

[63] 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) (released Feb. 14, 2013), *available at* http://gao.gov/assets/660/651322.pdf.

[64] *See* BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC, at 39-44 (July 30, 2012), *available at* http://bettermarkets.com/sites/default/files/CBA%20Report.pdf.

benefits of the law far exceeded the costs and lost profits that industry would have to absorb.[65]

Against the backdrop of the worst financial and economic crises since the Great Depression, it is inconceivable that Congress would enact sweeping reforms and then allow the implementation of those reforms to hinge on the outcome of a biased cost-benefit analysis that ignored the overriding purpose of the new regulatory framework—and that gave controlling weight to cost concerns from the very industry that precipitated the crisis and inflicted trillions of dollars in financial damage and human suffering across the country.

---

[65] *Id.* at 43.

COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

UNITED STATES SENATE

REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

STATEMENT OF WALTER L. LUKKEN
PRESIDENT AND CHIEF EXECUTIVE OFFICER
FUTURES INDUSTRY ASSOCIATION

July 17, 2013

Chairman Stabenow, Ranking Member Cochran and members of the Committee, thank you for the opportunity to provide our perspective on matters affecting the derivatives industry and in particular the regulation of our markets by the Commodity Futures Trading Commission (CFTC). As you turn your attention to reauthorizing the CFTC, the Futures Industry Association (FIA) stands ready to assist in any way we can. FIA is the leading trade organization for the futures, options and over-the-counter cleared derivatives markets. It is the only association representative of all organizations that have an interest in the listed derivatives markets. Its membership includes derivatives clearing firms, traders and exchanges from more than 20 countries. FIA's core constituency consists of futures commission merchants, commonly known as FCMs, and the primary focus of the association is the global use of exchanges, trading systems and clearinghouses for derivatives transactions.

As you know, clearing has long been an integral part of the futures market structure. Clearing ensures that parties to a transaction are protected from a failure by the opposite counterparty to perform their obligations, and the FCMs that FIA represent play a critical role in ensuring that transactions are secured with appropriate margin to facilitate this clearing process.

Improving Customer Protection

I would like to take this opportunity to update the Committee on recent efforts to improve the handling of funds and other collateral that customers deposit with FCMs to margin futures and cleared swaps positions. As you know, the failures of MF Global Inc. and Peregrine Financial Group resulted in severe and unacceptable consequences for futures customers and the markets generally. The entire industry has been working collaboratively to identify and improve procedures required to better protect the integrity of these markets. A number of changes are being implemented, many of which were recommended by FIA in the aftermath of these insolvencies[1]:

- The National Futures Association (NFA) and the CME Group (CME), the industry's principal self-regulatory organizations, have adopted rules that subject all FCMs to enhanced recordkeeping and reporting obligations. For example, chief financial officers or other appropriate senior officers are now required to authorize in writing and promptly notify the FCM's designated self-regulatory organizations (DSRO) whenever an FCM seeks to withdraw more than 25 percent of its excess funds from the customer segregated account in any day – these are funds deposited by the FCM into customer segregated accounts to guard against customer defaults.

- NFA and CME have launched an automated system for the daily monitoring of all customer segregated, secured, and cleared swaps amounts held by FCMs. As part of this project, NFA and CME contracted with AlphaMetrix360, a subsidiary of AlphaMetrix Group, to aggregate the data on customer segregated, secured, and cleared swaps amount accounts. The new system will allow NFA and CME to run an automated comparison of the balances in customer segregated, secured, and cleared swaps accounts at the depositories with the daily reports they receive from FCMs, and then quickly identify any discrepancies.

- NFA is also collecting additional financial information from FCMs and posting that information on its online Background Affiliation Status Information Center (Basic) system, a key step in giving customers the tools they need to monitor the assets they

[1] See Futures Industry Association, Futures Markets Financial Integrity Task Force - Initial Recommendations for Customer Funds Protection:
http://www.futuresindustry.org/downloads/Initial_Recommendations_for_Customer_Funds_Protection.pdf

deposit with their FCMs. The new service provides the public with access to specific information about an FCM, such as the firm's adjusted net capital, the amount of funds held in segregated, secured, and cleared swaps accounts, and the types of investments that the FCM is making with those customer funds.

- NFA has also proposed an interpretive notice that contains specific guidance and identifies the minimum required standards for FCM internal controls such as separation of duties; procedures for complying with customer segregated and secured amount funds requirements; establishing and complying with appropriate risk management and trading practices; restrictions on access to communication and information systems; and monitoring for capital compliance. This notice is in addition to more stringent internal control standards recently developed by the NFA, CME and other self-regulatory organizations.

- A set of frequently asked questions on customer funds protection[2] has also been developed by FIA, which is being used by FCMs to provide their customers with increased disclosure on the scope of how the laws and regulations protect customers in the futures markets.

- Additionally, FIA, CME Group, NFA, and the Institute for Financial Markets have partnered to fund an evaluation of the costs and benefits of various asset protection insurance proposals. We look forward to sharing these findings with the Committee when available in the coming weeks.

In addition to the efforts undertaken by the industry, the CFTC has recently proposed a set of comprehensive regulations to further enhance customer protection. To a significant extent, the

[2] See Protection of Customer Funds, Frequently Asked Questions: http://www.futuresindustry.org/downloads/PCF-FAQs.PDF

proposed rules build upon and codify the recommendations that FIA made and rules that the DSROs have adopted. FIA endorses the regulatory purposes underlying the proposed amendments. We nonetheless submitted an extensive comment letter designed, in substantial part, to assist the Commission in striking an appropriate balance among its several proposals to assure that the producers, processors and commercial market participants that use the derivatives markets to manage risks will be able to continue to have cost-effective access to the markets and a choice of FCMs. In particular, we would like to make the Committee aware that contained within the proposal is a significant modification to the Commission's current interpretation of how customer margin obligations will be determined and when an FCM must calculate each customer's segregation requirement and inject its own resources (commonly referred to as "residual interest") into the customer's account. This re-interpretation of the long-standing application of the statute will result in a tremendous drain on liquidity that will make trading significantly more expensive for customers hedging their financial or commercial risks, and will adversely affect the ability of many FCMs to operate effectively. It should be noted, that the Commodity Exchange Act has not changed in this regard since 1936 and is silent on the timing of such calculations.

This re-interpretation would require FCMs to assume that ALL margin calls from each customer are simultaneously not able to be collected, resulting in customers being asked to pre-fund their margin or pay to use the capital of the FCM as an injection into the customer account. The costs to the industry as a whole would be significant: Assume a grain elevator places a short corn hedge at the open on Monday morning. During Monday's trading, adverse news drives the price of corn limit up ($0.40). Under the new interpretation, the FCM will need to require the elevator to have sufficient money in the account before placing the trade on Monday to cover initial margin as well as a daily limit move. This "prefunding" is a problem for the elevator because it forces the elevator to keep excess funds at the FCM at all times. It is also a problem for the elevator's bank, because banks will generally not lend for margin until the position has been established and the FCM provides a confirmation of the position to the bank.

The current interpretation was essential to the performance of the futures industry during the 2008 crisis and its application is not related to the shortcomings identified after the recent failures. When the proposal was released the Commission acknowledged that it did not have adequate information to determine the costs of the modified residual interest requirement[3]. Consequently, FIA engaged a consultant to sample FCMs on the potential costs of the residual interest proposal; the results show that this change could require an additional $100 billion obligation to the customer funds accounts, beyond the sum required to meet initial margin requirements. Many of the very customers this proposal is designed to benefit have expressed concerns, both to the CFTC and to this Committee, as they rightfully realize that the proposal will significantly increase the costs of hedging and likely have the largest impact on small to mid-sized FCMs which could potentially lead to consolidation and fewer choices for them as customers. As previously mentioned, the FIA supports many of the customer protection measures that the Commission has proposed we simply believe this one in particular has not been justified and is not warranted.

The FIA is very engaged in the development of industry and Commission-initiated efforts to proactively address many of the issues presented by these recent failures. While the derivatives industry is strong, and clearing continues to be the gold standard in protecting market participants from the unexpected failure of counterparty, we recognize that the collateral necessary for a robust clearing system, and the customers who post such margin, are better protected through enhanced disclosures, reporting, and internal controls. Our members commit a substantial amount of their own capital to guarantee customer transactions. We have every incentive to ensure that the integrity of the derivatives clearing system is well-regarded as safe and reliable.

Clearing Under the Dodd-Frank Act

While the last regular review of the statute occurred five years ago under the routine CFTC reauthorization process, the Commodity Exchange Act has undergone significant changes as

[3] See 77 FR 67916

recently as three years ago, when under the Dodd-Frank Act, Congress determined to extend clearing beyond futures to swaps. As such, the role of the FCMs has also expanded. Because FCMs play a critical role in achieving the newly-established clearing regime for swaps, we are happy to offer our thoughts on the implementation of these requirements.

To date, much of the debate surrounding the implementation of the swaps clearing requirements under the Dodd-Frank Act has been focused on who, what, when and where, rather than how. Often, public attention to Title VII implementation has been devoted to what products will be subject to the clearing mandate; who will be expected to comply with the mandate; when they will be expected to comply; and where, within the global markets, the products and participants will be regulated – all very important questions, but far less discussion has been devoted to how the mechanics of clearing are being impacted. It must not be overlooked that both derivatives clearing organizations and FCMs face tremendous structural changes under some of the new rules, despite the fact that neither of these regulated entities were a contributing factor in the financial crisis. Quite the opposite—the regulated and cleared futures markets worked extraordinarily well during this financial stress, which is the principal reason that the futures markets are serving as the model for this new swaps marketplace. Certainly, the regulatory policies and benefits that have historically existed for clearing futures can largely be applied to swaps – I believe that is what Congress envisioned when passing the Dodd-Frank Act. There will obviously be the occasional exception necessitated by the fact that swaps and futures have evolved in different environments. However, there is no need to re-invent the already proven system that is familiar and tested for futures, especially at this critical juncture, when the newly required clearing mandate for swaps is beginning to take effect. Further, it is important as we implement these important changes in the market structure for swaps that we don't irreparably damage the futures markets that have served our industry well over the last decades. FIA members want a safe and transparent system and want to be constructive in helping to build it. FCMs stand ready and willing to facilitate the clearing of swaps, just as they have for futures. It is for this reason that FIA discourages policies that complicate the process, especially given the existence of familiar rules that have long governed the clearing of futures.

Conclusion

In general, markets function more effectively and with less disruption when the rules of engagement are clear, simple and transparent and when there is enough time for businesses to adjust their activities to achieve compliance.

I am fortunate to represent a wide array of stakeholders in the listed, cleared and regulated derivatives industry – all of whom want to see this industry continue to support the risk management needs of its customers in a productive way. This is a goal I know the members of this Committee share and I look forward to working with you as you consider the CFTC's role in achieving this mutual objective.

NFA

TESTIMONY OF DANIEL J. ROTH
PRESIDENT AND CHIEF EXECUTIVE OFFICER
NATIONAL FUTURES ASSOCIATION

BEFORE THE UNITED STATES SENATE COMMITTEE
ON AGRICULTURE, NUTRITION & FORESTRY

July 17, 2013

Chairwoman Stabenow, Ranking Member Cochran, Members of the Committee, thank you for the opportunity to testify at this important hearing. My name is Daniel Roth and I am the President of National Futures Association. As Congress begins the reauthorization process, customer protection issues should be front and center in everybody's mind. Customer protection is the heart and soul of what we do at NFA, and for years the futures industry had an impeccable reputation for safeguarding customer funds. Since Congress last considered reauthorization, though, that reputation has taken a serious hit. First at MF Global and then at PFG, customers suffered very real harm from shortfalls in customer segregated funds, the kind of harm that all regulators seek to prevent. Clearly, dramatic improvements had to be made. In the wake of MF Global and PFG, NFA has worked very closely with the CME, other self-regulatory organizations and the CFTC to bring about those improvements. Let me start by highlighting the steps we have already taken.

Daily Confirmation of Segregated Account Balances

For years NFA and other SROs confirmed FCM reports regarding the customer segregated funds held by the FCM through traditional paper confirmations mailed to the banks holding those funds. These confirmations were done as part of the annual examination process. In early 2012 NFA began confirming bank balances electronically through an e-confirm process. That change led to the discovery of the fraud at PFG, but e-confirms were still done as part of the annual examination. We had to find a better way and we did.

We partnered with the CME and developed a process by which NFA and the CME confirm all balances in all customer segregated bank accounts on a daily basis. FCMs file daily reports with NFA and the CME, reflecting the amount of customer funds the FCM is holding. Through a third party vendor, NFA and CME get daily reports from banks for the over 2,000 customer segregated bank accounts maintained by FCMs. We then perform an automated comparison of the reports from the FCMs and the reports from the banks to identify any suspicious discrepancies. In short, Madam Chairwoman, the process by which we monitor FCMs for segregated fund compliance is now far ahead of where it was just one year ago.

We are working with the CME to expand this system to also obtain daily confirmations from other types of depositories, such as clearing firms and clearinghouses. That expansion should be complete by the fourth quarter of this year.

Customer Account Insurance

In light of the failures of MF Global and PFG there have been renewed calls for some form of customer account insurance. As we begin this discussion, we should bear in mind three points. First, customer account insurance can take many forms. There are alternatives to the SIPC, government sponsored model. Private insurance solutions can take several forms in terms of who is covered and to what extent. Second, public confidence in the markets is critical, but it is a means to an end. The real goal is to ensure that futures markets are effective and efficient and a benefit to the economy. Markets must therefore be liquid and that requires public confidence. However, attempting to bolster public confidence through insurance programs that prove to be cost prohibitive is self-defeating and would damage the liquidity we are trying to foster. Finally, this question is too important to be dismissed out of hand because various forms of insurance might be too expensive.

We need data, not hunches. We need to know what kind of insurance we would be buying and what we would be paying for it. Only then can Congress make an informed decision. With this in mind, NFA has joined with the CME, FIA and the Institute for Financial Markets to commission a detailed analysis of various alternative approaches to customer account insurance. Armed with detailed customer account information from small, medium and large FCMs, the study will calculate the estimated costs of each of the alternatives studied. We hope to have the results of the study by mid-September.

FCM Transparency

One of the lessons we learned from MF Global is that customers should not have to study the footnotes to an FCM financial statement to find out how their segregated funds are invested or other financial information about their FCMs. We had to make it easier for customers to do their due diligence on financial information regarding FCMs. For years, NFA required FCMs to file certain basic financial information with NFA, and that information is now posted on NFA's website for customer review. The information includes data on the FCM's capital requirement, excess capital, segregated funds requirement, excess segregated funds and how the firm invests customer segregated funds. This information is displayed for each FCM and includes historical information in addition to the most current data. The display of FCM financial information on NFA's website began in November 2012 and so far these web pages have received over 25,000 hits.

MF Global Rule

All FCMs maintain excess segregated funds. These are funds deposited by the FCM into customer segregated accounts to act as a buffer in the event of customer defaults. Because these funds belong to the FCM, the FCM is free to withdraw the excess funds, but after MF Global, NFA and the CME adopted rules to ensure notice to regulators and accountability within the firm. Now all FCMs must provide regulators with immediate notification if they draw down their excess segregated funds by 25% in any given day. Such withdrawals must be approved by the CEO, CFO or a financial principal of the firm and the principal must certify that the firm remains in compliance with segregation requirements. This rule became effective on September 1, 2012.

FCM Internal Controls

NFA, CME and other SROs developed more specific and stringent standards for the internal controls that FCMs must follow to monitor their own compliance with regulatory requirements. In May 2013, NFA's Board approved an interpretive notice that contains specific guidance and identifies the required standards in areas such as separation of duties; procedures for complying with customer segregated funds requirements; establishing appropriate risk management and trading practices; restrictions on access to communication and information systems; and monitoring for capital compliance. NFA submitted the interpretive notice to the CFTC on May 22, 2013, for its review and approval.

Review of NFA Examination Procedures

NFA's Special Committee for the Protection of Customer Funds—consisting of all public directors—commissioned an independent review of NFA's examination procedures in light of the PFG fraud. The study was conducted by a team from the Berkeley Research Group ("BRG") that included former SEC personnel who conducted that regulator's review of the SEC's practices after the Madoff fraud. BRG's report was completed in January 2013. The report stated that "NFA's audits were conducted in a competent manner and the auditors dutifully implemented the appropriate modules that were required." The report, however, also included a number of recommendations designed to improve the operations of NFA's regulatory examinations in the areas of hiring, training, supervision, examination process, risk management, and continuing education. NFA has already taken a number of steps to implement BRG's recommendations. A Special Committee appointed by NFA's Board is overseeing the timely implementation of these recommendations.

Both the PFG and MF Global bankruptcies highlighted the need for greater customer protections to not only guard against the loss of customer funds but also in the event of an FCM's insolvency. As discussed above, NFA has made and continues to implement changes to enhance the safety of customer segregated funds and guard against a shortfall in customer funds in the event of any future FCM failures.

NFA believes, however, that Congress should consider a number of possible changes to Bankruptcy Code provisions that govern an FCM's liquidation that would likely strengthen customer protections and priorities in the event of a future FCM bankruptcy. We fully recognize that any changes to the Bankruptcy Code regarding FCM insolvency protections will not be easy to achieve. Yet we strongly believe that the two recent FCM failures have highlighted the need for enhanced customer protections that can only be achieved via changes to the Bankruptcy Code.

We are in discussions with all facets of the industry to arrive at a consensus view on changes that should be made. Chief among NFA's concerns in this area is removing the uncertainty over the validity of the CFTC's definition of customer property. Other issues may include reviewing whether it is appropriate that all joint FCM/broker-dealer bankruptcies be administered under SIPA.

Detecting and combating fraud is central to our mission. No system of regulation can ever completely eliminate fraud, but we must always strive for that goal. The process of refining and improving regulatory protections is ongoing and the initiatives outlined above do not mark the end of our efforts. We look forward to working with Congress, the CFTC, SROs and the industry to ensure that customers have justified confidence in the integrity of the U.S. futures markets.

American Public Power Association
Ph: 202.467.2900
Fax: 202.467.2910
www.APPAnet.org

1875 Connecticut Avenue, NW
Suite 1200
Washington DC 20009-5715

APPA

STATEMENT OF DONALD RUSSAK,

EXECUTIVE VICE PRESIDENT and CHIEF FINANCIAL OFFICER, NEW YORK POWER AUTHORITY

before the

SENATE COMMITTEE ON AGRICULTURE, NUTRITION and FORESTRY

HEARING on

REAUTHORIZATION of the COMMODITY FUTURES TRADING COMMISSION

July 17, 2013

Chairwoman Stabenow, Ranking Member Cochran, and Members of the Committee, thank you for the opportunity to speak today on the reauthorization of the Commodity Futures Trading Commission (CFTC). I am Donald Russak, Executive Vice President and Chief Financial Officer for the New York Power Authority (NYPA), testifying on behalf of my utility, the state of New York, and the American Public Power Association (APPA).

NYPA is America's largest state power organization, with 16 generating facilities, and more than 1,400 circuit miles of high-voltage transmission lines. Our customers include: 115 government entities in New York City metropolitan area, including the City of New York, the Metropolitan Transportation Authority, the Port Authority of New York and New Jersey, the New York City Housing Authority, the County of Westchester and most Westchester municipalities, school districts and other public entities; 47 municipal electric systems and four electric rural cooperatives; numerous non-profit health-care, educational and cultural institutions within New York including museums, colleges and universities, and hospitals; and, public agencies in seven neighboring states—Connecticut, Massachusetts New Jersey, Ohio, Pennsylvania, Rhode Island, and Vermont. In addition, our low cost power is sold to businesses and industries in New York State which support and sustain more than 380,000 jobs.

NYPA and the municipal utilities it serves are members of APPA, the national service organization representing the interests of over 2,000 municipal and other state- and locally-owned, not-for-profit electric utilities throughout the United States (all but Hawaii). Collectively, these "public power" utilities [1] deliver electricity to one of every seven electricity customers in

[1] "Public power" is not defined in the law, but generally refers to government-owned utilities. This is distinguished from a "public utility" which generally refers to an investor-owned utility, as under the Public Utility Holding Company Act of 1935 and the Federal Power Act.

the United States (approximately 47 million people). APPA member utilities serve some of the nation's largest cities, but the vast majority serve communities with populations of 10,000 people or less.

I appear today to ask the Committee in reauthorizing the CFTC to include legislation that will allow my utility, and other public power and public natural gas utilities, to hedge against price risks on a level playing field with that of other utilities. Such legislation should provide the broadest market for us to hedge these risks, allowing us to better match hedging transactions to power and fuel price risks, and, so, protect all our customers from unnecessary price volatility. We believe that H.R. 1038, the Public Power Risk Management Act of 2013, would achieve this goal. The House approved H.R. 1038 with a 423-0 vote in June. We would hope that this Committee, and the Senate, would take up and approve this narrowly-crafted, widely-supported bill, but welcome any vehicle—including further action by the CFTC—that will effectively and expeditiously resolve our concerns.

Public Power Utilities and the Dodd-Frank Act

In the wake of the 2007 and 2008 financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) required the CFTC to provide comprehensive regulations for the swaps marketplace. Specifically, the Dodd-Frank Act requires greater reporting of swaps, allows the CFTC to require mandatory clearing for certain types of transactions, and requires swap dealers and major swap participants to register with the CFTC and meet capital, margin, and reporting and recordkeeping requirements, as well as to comply with rigorous business conduct and documentation standards. To address concerns that the legislation would force too many entities into the more stringent swap dealer regime, the Dodd-Frank Act included a "*de minimis* exception" to the definition of a swap dealer.[2]

Additionally, the Dodd-Frank Act provides more rigorous standards for a swap dealer or major swap participant advising or entering into a swap with a "special entity." As defined under the Dodd-Frank Act, a special entity is any public power or natural gas utility, any other government entity, a charitable organization or a pension plan.[3] For a swap dealer acting as an advisor to a special entity, the law states that the swap dealer has a duty to act in the best interest of the special entity.[4] A swap dealer or major swap participant entering into a swap with a special entity must have reason to believe that the special entity has a qualified independent representative.[5]

---

[2] 7 USC § 1a(49)(D); Letter from S. Comm. on Banking, Hous. & Urban Affairs Chairman Christopher Dodd and S. on Agric., Nutrition, & Forestry Chairman Blanche Lincoln to H. Comm. on Fin. Serv. Chairman Barney Frank and H. Comm. on Agric. Chairman Collin Peterson (June 30, 2010)(stating that "Congress incorporated a de minimis exception to the Swap Dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk are not inadvertently pulled into additional regulation.").
[3] 7 USC § 6s(h)(2)(C).
[4] 7 USC § 6s(h)(4).
[5] 7 USC § 6s(h)(5).

We believe the Dodd-Frank Act will provide needed transparency and certainty to swaps markets and support providing the resources necessary to the CFTC to fulfill its obligations under the Commodity Exchange Act, including implementation of the Dodd-Frank Act.[6] APPA and other interested parties have worked closely with the CFTC to improve implementation of the Dodd-Frank Act, particularly related to regulations affecting "end users"—that is, nonfinancial parties that enter into swaps to hedge or mitigate their commercial risks. NYPA and other APPA members are "end users." Dozens of new regulations affect public power utilities, and APPA and a coalition of not-for-profit electric utilities have submitted formal comments on 17 specific regulations proposed by the CFTC and Securities and Exchange Commission (SEC) as part of their implementation of the Dodd-Frank Act. One such instance is the rule defining "swap dealer."[7]

In December 2010, the CFTC jointly with the SEC issued a proposed rule to define the term "swap dealer," including (as discussed above) an exception from the swap-dealer designation for those entities that engage in a *de minimis* quantity of swap dealing. In the proposed rule, the CFTC proposed two separate *de minimis* thresholds relating to the dollar quantity of swaps: $100 million annually for an entity's total swap-dealing activity; and, $25 million annually for an entity's swap-dealing activity with special entities, including, as noted above, public power, public gas, and federal utilities.

In February 2011, the Not-For-Profit Electric End User Group (NFP EEU)—which includes APPA—filed comments on the proposed swap dealer rule. The comments recommended that the CFTC substantially increase the *de minimis* threshold both for total swaps and for swaps with special entities.

A final swap dealer rule was approved by the CFTC on April 18, 2012, and was published in the *Federal Register* on May 23, 2012. The final rule greatly increased the overall *de minimis* threshold from the proposed rule, raising it from $100 million to $8 billion temporarily, and $3 billion over time. But, the final rule did <u>not</u> change the proposed rule's $25 million sub-threshold for swap-dealing activities with special entities. Thus, the disparity between the two thresholds is now substantially greater. This $25 million sub-threshold is smaller still when you consider that it is the aggregate of a swap partner's transactions with <u>all</u> special entities during any 12-month period.[8]

The swap dealer rule became final on July 23, 2012. Swap dealer registration regulations went into effect on October 12, 2012, at which time entities were required to begin counting their "swap dealing" activities. Those with dealing activity in excess of the *de minimis* thresholds must register as swap dealers.

---

[6] See, for example, Letter from Commodities Mkts. Oversight Coal. to the S. Subcomm. on Fin. Serv. (June 24, 2013)(co-signed by APPA and urging full-funding for the CFTC in Fiscal Year 2014 appropriations process).
[7] CFTC Regulation 1.3(ggg)(4); see 77 Fed. Reg. 30596, at 30744.
[8] By way of reference a single, one-year 100 MW swap could have a roughly $25 million notional value. One-hundred MWs of power is enough to serve the average demand of approximately 75,000 residential customers.

As a result, nonfinancial entities (such as natural gas producers, independent generators, and investor-owned utility companies) that do not want to be swap dealers have limited their swap-dealing activities with public power utilities to avoid exceeding the $25 million threshold. This greatly hinders public power utilities' ability to hedge against operational risks. Just like NYPA, these utilities have no shareholders, so the costs imposed by this regulatory decision will be borne by only one group: public power customers.

Why Hedging Is Necessary

Public power utilities depend on nonfinancial commodity transactions, trade options, and "swaps," as well as the futures markets, to hedge commercial risks that arise from their utility facilities, operations, and public service obligations. Together, nonfinancial commodity markets play a central role in the ability of public power utilities to secure electric energy and fuel for generation at reasonable and stable prices.

Specifically, many public power utilities purchase firm electric energy, fuel and natural gas supplies in the physical delivery markets (in the "cash" or "spot" or "forward" markets) at prevailing and fluctuating market prices, and enter into bilateral, financially-settled nonfinancial commodity swaps with customized terms to hedge the unique operational risks to which many public power utilities are subject. Additionally, many public power utilities have used the swaps and futures products to hedge their excess electric generation capacity, thus providing revenue and rate certainty to their customer/owners. In hedging, mitigating or managing the commercial risks of their utility facilities' operations or public service obligations, public power utilities are engaged in commercial risk management activities that are no different from the operations-related hedging of a private, for-profit, investor-owned utility or a non-profit, private electric cooperative.

Why Nonfinancial Counterparties Are Necessary

Electric power touches virtually every home and business in the United States. This near universality gives a false appearance of homogeneity. It is important to remember that what is being delivered, either power or fuel to provide power, is a physical commodity, e.g., electricity, coal, and natural gas. Ownership of a stock can be transferred coast to coast with a click of a button, but electricity must be delivered to the place it is to be used. Further, storage of electricity for future use, unlike other commodities such as gasoline, grain, or coffee, is not currently viable on a large scale and thus electricity must be produced at the time it is used.

Each regional geographic market has a somewhat different set of demands driven by climate, weather, population, and industrial activity, among other factors. Each regional geographic market also has a somewhat different group of financial entity counterparties and nonfinancial entity counterparties available to meet these demands and thus able to enter into utility operations-related swaps needed for hedging price and supply risks. For example, a large merchant electric generation station in western Alabama might be available as a nonfinancial counterparty for a swap transaction to provide electricity to a specific site in Alabama. But that same entity would not necessarily be able to offer the electricity in Oregon, and so would not be able to help an Oregon-based utility hedge its risks. Further, owners of electric generation facilities and distribution utilities operate in their geographical proximity. This is true whether they are investor-owned utilities, cooperative utilities, merchant generation companies, or public power utilities, and they are the most likely trading counterparties in their regions. These regional market participants, unlike financial entities, have a vested interest in maintaining the reliability of the grid and ensuring that sufficient liquidity exists to manage their operations.

In Regional Transmission Organization (RTO) markets such as the Pennsylvania-New Jersey-Maryland Interconnection (PJM) and the New York Independent System Operator (NYISO), the market design is such that using financial swaps and futures contracts to manage risk is now the standard. This is because the RTO markets provide unlimited physical liquidity in the day-ahead and real-time markets to ensure reliability of service. Thus, converting a financial price hedge to a physically delivered product in real-time is, by design, the way these RTO markets function.

Because there are a limited number of counterparties for any particular operations-related swap sought by a utility, each financial or nonfinancial swap counterparty brings important market liquidity and diversity: the greater the number of counterparties, the greater the price competition. Conversely, reduced price competition necessarily increases prices.

NYPA and the Special Entity Sub-Threshold

I would like to illustrate these points with examples from NYPA's perspective. NYPA was created to help provide a continuous and adequate supply of dependable electric power and energy to the people of the State of New York. The electric energy, generation-fuel and related products required or produced by NYPA and its customers are subject to the forces of unregulated, wholesale commodity markets. As such, the prices of these products are volatile and uncertain, in turn, exposing NYPA's financial position and its customers' rates to significant uncertainty, including price risk. NYPA uses hedging transactions to reduce its market risk, to stabilize revenue and, most importantly, to provide rate certainty to many of its customers, including nearly 2,000 megawatts of governmental customer load in the New York City metropolitan area and several hundred megawatts of business customer load statewide.

NYPA's approach to hedging has been to enter into agreements with the most active and experienced physical and financial counterparties with solid credit ratings. NYPA routinely seeks quotes from a number of potential counterparties before entering into a hedging transaction. As NYPA's transactions are conducted in a major Regional Transmission Organization market, NYPA relies primarily on financial swaps and futures contracts to manage its risk. Following the implementation of the special entity sub-threshold rule, several utility end users have refused to enter into financial hedging transactions with NYPA due to NYPA's status as a "special entity." These counterparties cite the compliance risk of exceeding the $25 million sub-threshold and the extensive recordkeeping and reporting responsibilities that would follow if they were deemed to be a "Swap Dealer" under CFTC regulations. As a result, the number of eligible counterparties willing to provide competitive quotes to NYPA has been reduced, which will naturally lead to increased costs being borne by our governmental and business customers, imperiling jobs and increasing taxes.

Public Power Utilities' Petition for Rulemaking

On July 12, 2012, APPA, the Large Public Power Council (LPPC), the American Public Gas Association (APGA), the Transmission Access Policy Study Group (TAPS), and the Bonneville Power Administration (BPA), filed with the CFTC a "Petition for Rulemaking to Amend CFTC Regulation 1.3(ggg)(4)." The petition requests that the CFTC amend its swap-dealer rule to exclude utility special entities' utility operations-related swap transactions from counting towards the special-entity threshold. This amendment to the swap-dealer rule would allow a producer, utility company, or other nonfinancial entity to enter into energy swaps with public power utilities without danger of being required to register as a "swap dealer" solely because of its dealings with public power utilities.

Specifically, the petition asks for a narrow exclusion:

- A public power (or natural gas) utility's swaps related to utility operations would not count towards the special entity *de minimis* threshold, but would count towards the total *de minimis* threshold.

- Utility operations-related swaps are those entered into to hedge commercial risks intrinsically related to the utility's electric or natural gas facilities or operations, or to the utility's supply of natural gas or electricity to other utility special entities, or to its public service obligations to deliver electric energy or natural gas service to utility customers. For example, these would include swap transactions related to the generation, production, purchase, sale, or transportation of electric energy or natural gas, or related to fuel supply of electric generating facilities.

- Utility operations-related swaps do not include interest rate swaps. Those swaps would remain subject to the $25 million special entity sub-threshold.

CFTC "No Action" Letter

CFTC released on October 12, 2012 a no-action letter from its Division of Swap Dealer and Intermediary Oversight (Division) relating to the $25 million special entity sub-threshold.[9] The letter states that the Division will "not recommend that the Commission commence an enforcement action" against a counterparty dealing in up to $800 million in swaps with public power utilities without registering as a swap dealer. As the Division explained in that letter, the $800 million is derived from a comment letter endorsed by the NFP EEU group suggesting that the special entity sub-threshold be set at 1/10th that of the overall swap dealer threshold.

The no-action letter was a result of hours of meetings with CFTC Commissioners and staff, who we believe made a good faith effort to resolve this issue in the midst of implementing a comprehensive reform of our nation's financial system. We also believe that input and inquiries

[9] Commodity Futures Trading Comm'n, No-Action Letter, Letter No. 12-18 (Oct. 12, 2012).

from lawmakers and staff, including from this Committee, provided assurances to the CFTC that such relief would be welcomed.

The no-action letter, however, has failed to resolve this issue, in part because it included a number of additional limitations on a counterparty wishing to take advantage of the relief provided by the letter. Specifically, under the terms of the CFTC's no-action letter, the $800 million threshold applies only:

- If the special entity that is a party to the swap is using the swap to hedge a "physical position;"

- If the counterparty is not a "financial entity" as defined in the Commodity Exchange Act;

- If the swap is related to an exempt commodity in which both parties transact as part of the "normal course of their physical energy businesses;" and

- If a counterparty wanting to take advantage of the relief provided by the no-action letter files with the CFTC a notice that it is making use of the relief and provides, by December 31 (and quarterly thereafter), a list of each utility special entity with which it has entered into swaps and the total gross notional value of those swaps.

Certain counterparties have expressed concerns over one or more of the conditions imposed in the no-action letter. We believe that counterparties also simply are not willing to spend the time and money to create a separate compliance process and adjust their policies and procedures in order to facilitate transactions with the small segment of any particular regional market that utility special entities represent. This is especially likely now as counterparties are focused on implementing compliance programs dealing with the whole range of Dodd-Frank requirements. Finally, there is the overarching issue that the no-action letter, by definition, is temporary and can be revised or revoked without any of the steps of a formal rulemaking process.

Whatever the reason, the no-action letter has failed to provide nonfinancial counterparties with the assurances they need to enter into swap transactions with NYPA or other APPA members.

A November 19, 2012, letter to the CFTC from APPA explaining this outcome and support from several CFTC commissioners for relief[10] have failed to produce further action from the CFTC. As a result, some CFTC commissioners and staff, while preferring to correct the sub-threshold issue through regulations, have said public power utilities should also, or instead, seek relief from Congress.

---

[10] Statement of Bart Chilton, Comm'r, Commodity Futures Trading Comm'n (April 3, 2013)(describing an "end-user bill of rights" including the right of "public power end users using swaps to hedge commercial risks (to) the same access to risk management markets as privately-owned utilities"); Scott O'Malia, Comm'r, Commodity Futures Trading Comm'n, Keynote Address to Energy Risk USA 2013 (May 14, 2013)(stating that "in trying to protect Special Entities from the perils of trading in the swaps market, we have forced them to trade with large Wall Street banks since no other entity is willing to trade with them for fear of becoming a swap dealer").

<u>The Public Power Risk Management Act</u>

On March 11, 2013, the Public Power Risk Management Act of 2013 (H.R. 1038) was introduced by Congressman Doug LaMalfa (R-CA), a member of the House Committee on Agriculture, with fellow committee members Jim Costa (D-CA), Jeff Denham (R-CA), and John Garamendi (D-CA), along with House Financial Services Committee member Blaine Luetkemeyer (R-MO).

The legislation was approved by a unanimous voice vote in the House Committee on Agriculture on March 20, 2013. It was taken up by the full House under suspension of the rules on June 12, 2013, and passed 423-0. After being sent to the Senate, the legislation was referred to this Committee for its consideration.

The legislation largely mirrors the intent and effect of the public power utility petition to the CFTC, providing narrowly targeted relief for operations-related swaps for public power utilities. Specifically, the legislation would provide that the CFTC, in making a determination to exempt a swap dealer under the *de minimis* exception, must treat a utility operations-related swap with a utility special entity the same as a utility operations-related swap with any entity that is not a special entity.

Under the current threshold/sub-threshold regulatory regime adopted by the CFTC, this would mean that utility operations-related swaps with a public power (or public natural gas) utility would not be counted in calculating whether swap dealing activity exceeded the $25 million special entity *de minimis* threshold, but would be counted in calculating whether swap dealing activity exceeded the $8 billion *de minimis* threshold. Certainly, that is the legislation's intent.[11]

The legislation carefully defines which entities would qualify as a "utility special entity." It also specifically defines the types of swaps that could and could not be considered a "utility operations-related swap." For example, the legislation specifically would prohibit an interest, credit, equity, or currency swap from being considered a utility operations-related swap. Likewise, except in relation to their use as a fuel, commodity swaps in metal, agricultural, crude oil, or gasoline would not qualify either. Finally, the legislation also confirms that utility operations-related swaps are fully subject to other swap reporting requirements created under the Dodd-Frank Act.

When implemented, this legislation should provide the certainty to a nonfinancial entity that it can enter into a swap transaction with a public power utility without fear of being deemed a swap dealer. It truly levels the playing field, and it does nothing to otherwise alter the CFTC's implementation of the Dodd-Frank Act.

We wish the legislation were not necessary, but given the realities we face and the ongoing damage being done under the current rules, we urgently request the members of this committee

---

[11] H.R. Rep. No. 113-107, at 1 (2013) (stating, "In effect, the counterparties of utility special entities would no be subject to the much higher $8 billion de minimis swap dealer registration threshold.").

to support this narrow legislative fix, either by advancing H.R. 1038 or by including similar relief in legislation reauthorizing the CFTC.

Conclusion

In conclusion, the protections the CFTC affords through the $25 million special entity sub-threshold are not needed for utility operations-related swaps entered into by public power utilities, which are well-versed in the markets in which they hedge price and operational risks. In fact, by driving non-financial counterparties away from entering swaps with public power utilities, the sub-threshold limits the number of market participants with whom public power utilities can hedge their risk. Ultimately, this will increase operational risks and hurt our customers.

As a result, we very much appreciate this Committee's longstanding interest in this issue. We will continue to work with this Committee, Congress, and the CFTC to craft an appropriate and narrow solution, such as the relief proposed in our petition before the CFTC or in H.R. 1038.

Thank you again for this opportunity to testify, and I would be more than happy to answer any questions you might have.

DOCUMENTS SUBMITTED FOR THE RECORD

JULY 17, 2013

American Bankers Association
Building Success. Together.

James C. Ballentine
Executive Vice President
Congressional Relations & Political Affairs
202-663-5359
jballent@aba.com

May 1, 2013

SUBMITTED ELECTRONICALLY

The Honorable Debbie Stabenow
Chairman
Committee on Agriculture, Nutrition and Forestry
United States Senate
Washington, D.C. 20510

The Honorable Thad Cochran
Ranking Member
Committee on Agriculture, Nutrition and Forestry
United States Senate
Washington, D.C. 20510

Dear Chairman Stabenow and Ranking Member Cochran:

The American Bankers Association (ABA) appreciates the opportunity to participate in the comprehensive review of the Commodity Exchange Act (CEA) and Commodity Futures Trading Commission (CFTC) regulatory oversight. As noted in your request, this reauthorization comes at a challenging time. Not only has the CFTC remained responsible for oversight of the futures markets, but also it has proposed and finalized dozens of rules to implement the new regulatory framework required by the Dodd-Frank Act.

ABA encourages the Committee to address the following issues related to the new swaps regulations during the reauthorization: implementation transition, cross-border jurisdiction, eligible contract participant (ECP) definition, and risk-based measurement for the clearing exemption.

Implementation Transition

New swaps regulations must be implemented carefully so that they do not unnecessarily interfere with bank or bank customer risk management. The vast majority of banks use swaps to hedge or mitigate risk from their ordinary business activities, including lending. Hedging and mitigating risk are not only good business practices generally, but are important tools that banks use to comply with regulatory requirements to prudently manage risks associated with their assets and liabilities.

Some banks also give customers the option of using swaps to hedge and mitigate their loan risk from changes in interest rate or currency exchange rates. Farmers and energy companies may want to hedge against price changes in commodities. Swaps can be used for all of these purposes.

If banks cannot afford to continue using swaps to hedge risk because the regulations are too burdensome or are not implemented in a way that ensures a smooth transition, it will affect their ability to provide long-term, fixed rate financing. Customers may find long-term business planning difficult and may hesitate to borrow if they are only able to get short-term loans or loans with variable interest rates. They may also defer other business plans if they do not have a cost-effective way to hedge and mitigate their foreign currency, commodity price, or other risks.

The new regulatory framework for the swaps markets is not yet complete. Banks, bank customers, and other market participants need clarity as the new regulations are implemented. ABA believes that clear rules and interpretive guidance as well as appropriate no-action relief will ensure a smooth transition for swaps markets.

Cross-Border Jurisdiction

Banks operating globally also need clarity about the jurisdictional scope of the U.S. regulatory requirements. Although Title VII of the Dodd-Frank Act includes provisions that generally limit its extraterritorial reach, the language does not clearly delineate a standard for determining which cross-border activities should be subject to U.S. jurisdiction. Nor does it address the competitive imbalances that might arise if swaps regulations apply differently to banks depending on the country where they are headquartered.

The CFTC has issued proposed guidance and an exemptive order to address the applicability of Title VII regulations to cross-border swaps transactions. The Securities and Exchange Commission (SEC) has indicated that it will issue a proposed rule addressing security-based swaps transactions. In the meantime, banks operating globally are uncertain about which U.S. regulatory requirements may or may not apply to some of their derivatives activities and whether the jurisdictional scope may differ depending on whether the bank is headquartered in the United States or in another country.

ABA supports the goal of promoting consistency between the cross-border application of all Title VII rules. Market participants that engage in swaps and security-based swaps need clarity and would benefit from consistency between CFTC and SEC rules.

Eligible Contract Participant Definition

ABA has previously asked the CFTC for rulemaking, interpretive guidance, or exemptive relief on the eligible contract participant (ECP) definition. The ECP definition is a key component of the new regulatory framework for the swaps markets, since it will be illegal to enter over-the-counter (OTC) swaps with non-ECPs. Many swaps will still be OTC transactions because they are exempt from clearing or they are customized to meet individual customer needs, so banks and their customers need clarity about which individuals or entities will be ECPs.

Following ABA's request, the CFTC staff subsequently issued helpful interpretations and no-action relief on some issues related to the ECP definition. However the no-action relief only addressed interest rate swaps. Furthermore, the Commission has not yet taken formal action and the no-action relief will expire no later than June 30, 2013.

Absent formal Commission action, banks and their customers will be left wondering whether they will be able to engage in certain swaps transactions or, if they do, whether the swaps will be subject to rescission or possibly a private right of action once the no-action relief expires. The uncertainty is already having an impact on loan negotiations. Since it takes months to negotiate and close a loan, many of the loans currently being negotiated will not close until after the staff no-action relief expires. As a result, loan officers remain uncertain whether many of their customers will be able to use swaps to hedge commercial risk. This affects the customers' ability to repay the loan and the banks' ability to lend to those customers.

ABA believes that it is important that the CFTC act expeditiously to provide clarity and legal certainty to ensure the transition to the new regulatory regime does not unduly disrupt the lending markets. Absent clarity, banks will be unnecessarily discouraged from offering swaps to customers if it is unclear whether those customers will qualify as ECPs. The result will be decreased lending – especially to individual entrepreneurs and small and mid-size businesses – at a time when our country needs access to credit to ensure sustained economic recovery.

Risk-Based Measurement for Clearing Exemption

Many banks use swaps to hedge or mitigate risk the same way that other commercial end users do, but they were not automatically exempted from the swaps clearing requirements even though other end users were. This is incongruous considering that banks are already subject to comprehensive regulatory oversight.

Banks are required to have internal risk management practices and are subject to regular supervision by bank regulators. They are also subject to legal lending limits that cap the exposure that a bank may have to any individual or entity. As a result of the Dodd-Frank Act, legal lending limits will now explicitly include swap transactions in the measurement of credit exposure to another person.

The CFTC was required to consider an exemption from swaps clearing requirements for certain banks that use swaps to hedge or mitigate risk. Even though the CFTC's exemptive authority was not limited to institutions of a certain asset size, the Commission adopted a final rule exempting banks with total assets of $10 billion or less from the clearing requirements.

ABA asserts that a risk-based measurement for the end-user clearing exemption for banks would be more appropriate. For example, even banks with $30 billion or less in assets account for only 0.09 percent of the notional value of the bank swaps market as of December 2012. Rather than a $10 billion asset threshold or any other arbitrary asset threshold, a more appropriate measurement for the exemption might be in proportion with size of swaps portfolio and risk to the market. Swaps activity of this magnitude simply does not pose any significant risk to the safety and soundness of swap entities or to U.S. financial stability.

Conclusion

Thank you for your consideration of these issues that the ABA believes are essential to successfully functioning swaps markets. Please feel free to contact Edwin Elfmann at eelfmann@aba.com or Diana Preston at dpreston@aba.com if you have any questions or need additional information.

Sincerely,

James C. Ballentine

James C. Ballentine

American Cotton Shippers Association
88 Union Avenue, Suite 1204, Memphis, Tennessee 38103
PH: 901.525.2272 FX: 901.527.8303
www.acsa-cotton.org

May 6, 2013

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

The Honorable Thad Cochran
Ranking Member
Senate Committee on Agriculture, Nutrition, and Forestry
328-A Russell Senate Office Building
Washington, DC 20510

Dear Chairwoman Stabenow and Ranking Member Cochran,

The American Cotton Shippers Association ("ACSA") appreciates the opportunity to submit the following comments for consideration by the Senate Agriculture Committee ("Committee") in response to your letter dated March 7, 2013 requesting input on issues related to reauthorization that ACSA would like the Committee to consider during the upcoming process to reauthorize the Commodity Futures Trading Commission ("CFTC"). ACSA is comprised of Merchants, Primary Buyers and Mill Service Agents with members located throughout the cotton belt from coast to coast. ACSA's member firms handle over 80% of the U.S. cotton sold in domestic and foreign markets. The significant market involvement of ACSA members requires that the Association take an active part in promoting the increased use of cotton in the U.S. and throughout the world; establishing with other cotton trade organizations national and international standards for trade; collaborating with producer organizations throughout the cotton belt in formulating farm programs; and cooperating with government agencies in the administration of such programs.

Protection of Customer Collateral

Given recent events surrounding the collapse of two Futures Commission Merchants ("FCMs") and the mismanagement and disappearance of customer collateral, we request that the Committee consider the various market driven proposals to further protect these assets, as they are vital to our member companies and all other market participants seeking to manage risk in the derivatives markets.

Customer Protection Proposal

ACSA commends the efforts of the National Futures Association ("NFA") and the CFTC to improve certain aspects of how customer collateral is treated, although there is one particular issue raised by the CFTC that has caused opposition among our members. Specifically, ACSA strongly believes that the proposed requirement that FCMs maintain a residual amount sufficient to cover on a constant basis the aggregate of customer margin deficits could create liquidity issues and increase costs for FCMs and end-users. Such a decrease in liquidity could be substantial and limit the number and type of transactions FCMs clear, the number of customers they service, and the amount of financing they provide. The proposal would require FCMs to fund their customer segregated and secured accounts with proprietary assets in excess of the aggregated margin deficiencies of all its clients, at a minimum, prior to any margin payments being made to a clearinghouse. The proposal also appears to require executing FCMs to collect collateral for give-ups so that customer positions are fully margined in the event a clearing FCM rejects a trade.

If the proposed residual interest provision were to be finalized, FCMs may be forced to take steps such as over-margining clients, requiring clients to pre-fund their margin requirements, imposing punitive interest rate charges on margin deficit balances, and introducing intra-day margin calls. Such steps would dramatically increase the cost of using futures markets and may force many end-users to decrease or discontinue hedging and risk management practices, which is the reason these markets were created.

The industry has made significant improvements and has little more ability for change under the current regulatory regime. We encourage the Committee and the Congress overall to fully examine the variety of suggested legislative changes that have been offered by the market to create new options for collateral protection for FCMs who choose to offer them and customers who choose to use them. Included in this list is an option for full, individual collateral segregation in an individual custody account (likely requires a change to the Bankruptcy Code) as well as an insurance option. ACSA notes that there is an ongoing study into the cost of various insurance options being conducted, and we look forward to its findings.

End-User Concerns

The CFTC has been working diligently since the passage of Dodd-Frank in July of 2010 and should be commended for the progress they have made thus far. ACSA recognized and supported the need for reform in the over-the-counter (OTC) swaps market and believes that Dodd-Frank provided a foundation for an effective overhaul of this important risk-management market. However, there are various issues that have arisen as part of the implementation process which we believe the Committee should revisit going forward, as they have the ability to drastically affect liquidity in these vital risk-management tools, driving up the costs of energy and agricultural products, and leaving companies more exposed to price volatility, of which decreased liquidity is a contributing factor.

Part 1.35 Recordkeeping Requirements

A significant and concerning expansion of current data requirements beyond the scope of Dodd-Frank is related to recordkeeping requirements in Part 1 of Commission regulations. In accordance with Dodd-Frank, the CFTC expanded the futures recordkeeping requirements that existed for certain markets participants to swaps. However, they also significantly expanded the written requirements, as well as created a new requirement to record oral conversations. Compliance costs have already been incredibly substantial now that compliance with the written requirements is mandatory and will only increase once compliance with the oral recording requirement becomes mandatory later this year. Again, the market is searching for a reason and measurable benefit for all of this new information that must be maintained and archived in a particular way. In addition, the rule is vague as to which communications must be retained, so in an abundance of caution, market participants are effectively saving every email, news article, or any other piece of information that might "lead to the execution of a transaction" and soon will have to begin recording every phone call that might "lead to the execution of a transaction." Also, the application of the requirements to members of an exchange seems to have no regulatory rationale and only serves as a disincentive to be a member, something the Commission should encourage. Finally, there has been no sufficient cost benefit analysis to justify the cost figures by CFTC staff. Compliance costs are exponentially higher than they estimate, and in some cases the technology is not even available to market participants. Requests for clarification have not yet been answered, and ACSA will be submitting a written request soon in a continued effort to clarify and hopefully narrow the scope of what must be retained and, therefore, reduce compliance cost.

Real-Time Reporting

Under the real-time reporting rule, end-users have a longer time in which to report trades with other end-users. However, trades that involve a swap dealer or major swap participant must be reported in a much shorter time after execution. Because the rule requires trades between a non-dealer and a swap dealer be reported within the dealer's time limit, swap dealers and major swap participants have limited time to lay off risk before the trade is made public. While the delay may be sufficient for liquid markets, they are not sufficient for illiquid markets and time frames. When a dealer has to report such illiquid trades to the market quickly and the dealer may not be able to lay off the risk of that trade in the prescribed time, the dealer is taking a risk and will charge the counterparty (here, the commercial end-user) for that increased risk if they are willing to execute the trade at all. This increased cost and possible inability to trade in illiquid markets will hurt commercial end-users.

Inter-Affiliate Transactions

Inter-affiliate trades are subject to recordkeeping requirements under Part 45, requiring that the records of inter-affiliate swaps are "full, complete, and systematic." We view this requirement as burdensome and providing very little benefit relative to the increased cost to our members. The information that the Commission is seeking is available through the visibility of market-facing swaps, as they are largely identical. Additionally, these inter-affiliate and market-facing trades are for purposes of hedging or mitigating commercial risk and are documented pursuant to inter-affiliate agreement such that both parties must make payments and deliveries specified, although the transactions may be settled by an intercompany transfer or allocation. The internal documentation is done as necessary for internal purposes, but may not contain all information required or in the format required under Part 45.

With respect to mandatory clearing and the end-user exception, we appreciate the Commission's recent relief providing an exemption for swaps between commonly owned affiliates. The Commission still needs to clarify that swaps entered into by a centralized hedge function of a commercial entity are eligible for the end-user clearing exception when hedging on behalf of the commercial company, whether or not the entity housing the hedge function for the company is by definition a financial entity.

Bona Fide Hedging

Congress provided a definition of a bona fide hedge within Dodd-Frank that the CFTC has unnecessarily narrowed, including related to anticipatory hedging, and has created at least five different definitions in various rules of what constitutes a bona fide hedge. This is nonsensical and creates unnecessary confusion, while disruptive to legitimate risk mitigation practices. We are committed to working with Congress to set clearer direction on bonafide hedges so that transactions that limit economic risks are viewed as bona fide hedges by the CFTC.

In conclusion, the swap reforms in Dodd-Frank were not necessary because of problems in physical commodity markets. Commercial end-users had no role in creating the financial crisis. Given the increased compliance burden that now exists for end-users, ACSA looks forward to working with the Committee as this important process continues and appreciates the invitation to submit comments.

Sincerely,

William E. May
President & CEO

Shane J. Skelton
Policy Advisor

1220 L Street, NW
Washington, DC 20005-4070
Telephone (202) 682-8172
Fax (202) 682-8051
Email skeltons@api.org
www.api.org

May 1, 2013

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

The Honorable Thad Cochran
Ranking Member
Committee on Agriculture, Nutrition
and Forestry
United States Senate
328A Russell Senate Office Building
Washington, DC 20510

Dear Chairwoman Stabenow and Ranking Member Cochran,

The American Petroleum Institute ("API") appreciates the opportunity to respond to your request for input on the reauthorization of this year's version of the Food, Conservation and Energy Act, especially as it applies to implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), as implemented and enforced by the Commodity Futures Trading Commission (the "CFTC").

The implementation of Title VII has proven to be significantly more challenging, complex, and costly than anticipated, affecting end-users transacting in energy commodity and energy-related commodity markets, as well as the CFTC itself. This is evidenced by the delays provided by the CFTC for multiple compliance deadlines and the piecemeal issuance of no-action relief and staff interpretive guidance. A number of critical CFTC rulemakings implementing Title VII that will have a direct impact on end-users have not been finalized as of the date hereof. In the case of position limits for futures and swaps, the CFTC must reissue a proposed notice of rulemaking *in toto* because its previously issued final rule was vacated by a federal court ruling in September 2012.[1] In addition, several interpretive issues regarding the scope and applicability of key definitions, including the definition of "swap," set forth in Title VII remain unresolved.

The regulatory and commercial uncertainty created by the "one-size-fits-all" regulatory framework established under Title VII of the Dodd-Frank Act has disrupted the efficient operation of swap markets, particularly those related to energy commodities. Moreover, in light of the complexities imposed by the CFTC's implementation of Title VII, IntercontinentalExchange, Inc. ("ICE") converted a large number of widely-traded, liquid and standardized energy swaps offered as part of its over-the-counter market to financially-settling futures in October 2012. Since that time, there has been a continued and distinct migration of derivatives activity involving energy commodities from swap markets to futures markets. In API's view, the futurization of swaps calls into question the overall need

1 *Position Limits for Futures and Swaps*, Final Rule and Interim Final Rule, 76 Fed. Reg. 71,626 (Nov. 18, 2011), vacated and remanded, *International Swaps and Derivatives Association, et al. v. United States Commodity Futures Trading Commission*, Memorandum Opinion, Civil Action No. 11-cv-2146 (RLW) (Sept. 28. 2012).

for, and effectiveness of, Title VII of the Dodd-Frank Act as applied to energy markets. At a minimum, it highlights the need for specific, targeted reforms to Title VII that should be addressed by Congress as part of this year's reauthorization process.

Set forth below are several key issues relating to the implementation of, and compliance with, Title VII of the Dodd-Frank Act that API, on behalf of its membership, urges the Committee on Agriculture, Nutrition and Forestry (the "Committee") to consider:

A. OPTIONS AND FORWARD CONTRACTS WITH EMBEDDED VOLUMETRIC OPTIONALITY THAT PHYSICALLY SETTLE SHOULD BE EXCLUDED FROM THE DEFINITION OF "SWAP."

Under the CFTC's current guidance on the scope and applicability of the definition of "swap" set forth in Section 1a(47) of the Commodity Exchange Act ("CEA"), both (i) options that result in the physical delivery of a commodity when exercised and (ii) forward contracts with embedded volumetric optionality are generally subject to regulation under Title VII the Dodd-Frank Act as "swaps." Forward contracts involve two parties in the commercial marketing chain. These transactions ensure the efficient delivery of nonfinancial commodities to end-users, thereby enabling them to conduct their core businesses. These transactions are entered into with the express intent to physically settle when the options are exercised and, in the energy sector, are used to mitigate the price and supply risks associated with end-users' core businesses of producing, processing, merchandising or consuming energy commodities.

Notwithstanding any embedded volumetric optionality, physical delivery forwards do not pose a systemic risk or offer any other basis for the application of the comprehensive regulatory regime for swaps. Accordingly, Congress should amend CEA Section 1a(47)(B)(ii) to clarify that both physical forwards with embedded volumetric optionality and physically delivered options should be excluded from the definition of "swap." Such clarification would be entirely consistent with the intent underlying the current forward contract exclusion for swaps established by Congress in CEA Section 1a(47)(B)(ii).

B. END-USER FIRMS SHOULD NOT BE SUBJECT TO MARGIN REQUIREMENTS.

The imposition of mandatory margin and capital requirements as part of the Title VII regime is daunting to markets. Of particular concern is how the imposition of mandatory margin and capital requirements on swap dealers ("SDs") and major swap participants ("MSPs") will affect transactions with nonfinancial end-user counterparties. Although nonfinancial end-users are exempt from mandatory capital and margin requirements, there is a significant likelihood that SDs and MSPs may require nonfinancial end-users to margin transactions as a condition of transacting business. In addition, it is anticipated that SDs and MSPs will attempt to cover their own mandatory capital and margin costs by passing through such costs to their nonfinancial end-user counterparties. The imposition of margin requirements on nonfinancial end-users by their counterparties, as well as the pass through of SD or MSP capital and margin costs, will significantly increase transaction costs for nonfinancial end-users, particularly those in the energy sector, and could impair liquidity in these markets.

As a consequence, API urges Congress to amend CEA Section 4s(e) to state that nonfinancial end-user counterparties, even when transacting with SDs and MSPs, are exempt from swap margin rules promulgated by the CFTC and Prudential Regulators.[2] Further, Congress should affirmatively state that the CFTC and Prudential Regulators may not place limitations on the forms of collateral SDs and MSPs can accept from nonfinancial end-users if they voluntarily agree to collateralize a swap as a commercial matter.

C. CONGRESS SHOULD REQUIRE AFFIRMATIVE ACTION BY THE CFTC TO RESET THE *DE MINIMIS* EXCEPTION FROM THE DEFINITION OF "SWAP DEALER."

Pursuant to CFTC Regulation 1.3(ggg)(4)(ii)(C), the CFTC is required to reassess the level of the *de minimis* exception from the definition of "swap dealer" in early 2016 and determine whether the *de minimis* exception should (i) decrease from its current level of $8 billion to $3 billion or (ii) via a public rulemaking process, be set at a different level altogether. In the event that the CFTC fails to address this issue on a proactive basis, the *de minimis* exception will automatically reset to $3 billion in 2018.

API respectfully submits that such a significant change in the *de minimis* exception level will have a material impact on the market structure for swaps in the United States. Moreover, the prospect of a change in the level of the *de minimis* exception because of the CFTC's failure to proactively and transparently address this issue will create substantial uncertainty and undermine market confidence. As such, Congress should amend CEA Section 1a(49)(D) to require that any undertaking by the CFTC to change to the level of the *de minimis* exception must be undertaken as part of a formal rulemaking proceeding and subject to public notice and comment.

D. FEDERAL POSITION LIMITS SHOULD ONLY BE IMPOSED BY THE CFTC AFTER A FINDING OF NEED AND EFFECTIVENESS FOR A SPECIFIED CONTRACT.

Section 4a(a) of the CEA is clear that the Commission may only implement federal speculative position limits to prevent excessive speculation. Despite the Commission's concerns that unreasonable and abrupt price movements may result from the liquidation of large concentrated positions, the CFTC to date has not presented any empirical, quantifiable evidence that large position concentrations harm liquidity or the pricing of energy commodities.

With this in mind, Congress should amend CEA Section 4a(1) to require the CFTC to make an affirmative finding that the imposition of federal position limits for a particular energy commodity are a necessary and effective method to prevent, diminish, or eliminate excessive speculation. Further, Congress should direct the CFTC to conduct substantive cost-benefit analysis (i) establishing the need for the federal speculative position limits for a given derivatives contract, and (ii) discussing the effects that such limits may have on the markets for such contract(s). This cost-benefit analysis should be submitted

---

[2] API requests that that such clarification also extend to a financial entity acting on behalf of an entity that is a nonfinancial entity.

to Congress as part of a public report and published in the *Federal Register* for public notice and comment.

E. CONGRESS SHOULD CLARIFY THE SCOPE AND APPLICABILITY OF EXEMPTIONS FOR *BONA FIDE* HEDGE TRANSACTIONS OR POSITIONS TO ENSURE THAT THEY COVER CURRENT RISK-REDUCING PRACTICES.

Section 4a(c) of the CEA directs the CFTC to provide an exemption from position limits for derivatives transactions that qualify as *bono fide* hedge transactions or positions (each, a "*Bona Fide* Hedge"). Congress adopted a broad *Bona Fide* Hedge definition specifically for the purpose of allowing producers, processors, merchandisers and consumers of physical commodities to properly hedge their exposure to price risk, including anticipated price risk.[3] In prior reauthorizations, Congress has unequivocally supported the use of anticipated hedges by end-users as an efficient means of hedging price risk associated with underlying physical commodity operations, whether for merchandising, the purchase or sale of services or other purposes.

Based on the CFTC's recently vacated final rule on position limits, API is concerned that there is a significant risk that the CFTC will adopt an unduly narrow interpretation of the statutory definition of *Bono Fide* Hedge. Such a narrow interpretation will place significant limitations on end-users' ability to efficiently and effectively hedge or mitigate exposure to price risk. API understands that the potential adoption of an overly narrow interpretation of definition of *Bona Fide* Hedge by the CFTC is driven by concerns that a broader reading of this statutory definition could create regulatory loopholes that could be abused by market participants, particularly non-commercial, financial entities transacting in energy markets. However, the CFTC has not presented any empirical evidence supporting these concerns and, thus, they are purely hypothetical in nature. More importantly, the adoption of such a narrow interpretation of this definition is not consistent with clear language of CEA Section 4a(c) and API's understanding of Congressional intent underlying this provision – which is to facilitate end-users' ability to engage in derivatives transactions that mitigate their exposure to price risk in an effective, practical manner.

API urges Congress to use the reauthorization process to clarify (i) the full scope and applicability of the statutory definition of *Bona Fide* Hedge, and (ii) it's clear support of the use of anticipated hedges by end-users in order to reduce price risk associated with the operation of underlying physical commodity businesses. Specifically, API supports the CFTC's *bona fide* hedge exemption under existing CFTC Regulation 1.3(z), as adopted and implemented by the CFTC prior to the promulgation of the Dodd-Frank Act. Existing CFTC Regulation 1.3(z), *inter alia*, allows for positions to be classified as *bona fide* hedges so long as they normally represent a substitute for a cash market transaction or positions to be taken at a later time in a physical market channel. CFTC Regulation 1.31(z) also incorporates both enumerated and non-enumerated hedging transactions. API supports this

[3] In relevant part, CEA Section 4a(c)(1) unequivocally states that the definition of *bona fide* transaction or position "may be defined to permit producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to hedge their legitimate anticipated business needs for that period of time into the future for which an appropriate futures contract is open and available on an exchange."

version of the definition of *Bona Fide* Hedge, which takes into account the realities of mitigating risk in the commercial energy sector.

F. CONGRESS SHOULD CLARIFY THAT THE DEFINITION OF "FINANCIAL ENTITY" DOES NOT INCLUDE END-USERS WITH "CENTRAL DESKS."

The definition of term "financial entity" set forth in CEA Section 2(h)(7)(C)(i) and implementing CFTC regulations refers, in part, to provisions of federal banking law that currently includes the trading of physical commodities and the trading of related derivatives as "financial activity." Many end-users in the energy sector and in other commodity markets have separate affiliates that face the market on behalf of the entire company to trade commodities and derivatives, but such affiliates have no other assets and conduct no other activities.[4] As a consequence, such companies that effectively function as a central trading desk for the corporate enterprise likely fall in definition of "financial entity."

Because the current definition of "financial entity" treats end-users with "central desks" in the same manner as hedge funds, Congress's careful protections for end-users in Title VII of the Dodd-Frank Act are significantly undermined. In order to alleviate this situation and ensure end-users the fullest protections available, Congress should amend CEA Section 2(h)(7)(C) to clarify that an entity whose primary business is entering into swaps or other transactions on behalf of affiliates that are not "financial entities" does not fall within the definition of "financial entity" set forth in CEA Section 2(h)(7)(C)(i).

G. CONGRESS SHOULD CLARIFY THAT FINANCIAL ENTITIES MAY UTILIZE THE END-USER EXCEPTION TO MANDATORY CLEARING WHEN TRANSACTION ON BEHALF OF AN AFFILIATE THAT IS A NONFINANCIAL ENTITY.

CEA Section 2(h)(7) allows financial entities to exercise the end-user exception on behalf of non-financial affiliates if they act "on behalf of and as an agent of the nonfinancial affiliate." The CFTC has interpreted this phrase to require an actual agency agreement to be in place and to require that the nonfinancial end-user enter into the swap as principal. The narrow reading of this phrase vitiates Congress' intent that market-facing financial entities should be able to take advantage of the end-user exception if they are acting on behalf of nonfinancial affiliates. Requiring the nonfinancial end-user to enter into the swap as principal effectively eliminates the benefits realized by using central hedging affiliates and effectively renders futile financial entities' ability to exercise the end-user exception on behalf of nonfinancial affiliates. Congress should amend CEA Section 2(h)(7)(D)(i) by striking existing language requiring that a financial entity affiliate act "on behalf of a person and as an agent."

---

[4] Depending on their unique corporate structure, certain end-users in the energy sector may utilize (i) a single trading desk (*i.e.*, a centralized trading desk), or (ii) multiple trading desks. In either scenario, the trading activity of such end-users is generally subject to the oversight and monitoring of internal risk management and compliance personnel ("Risk Management Function"). Frequently, the Risk Management Function of an end-user will have responsibilities for the entire corporate enterprise. Given its separate and distinct role from trading, a Risk Management Function with enterprise-wide responsibilities should not fall within the definition of "financial entity."

H. THE CROSS-BORDER APPLICATION OF TITLE VII OF THE DODD-FRANK ACT BY THE CFTC SHOULD NOT HINDER U.S. INTERESTS ABROAD.

In light of the global operations of many U.S.-based energy companies, the effective and efficient implementation of Title VII outside of the U.S. is of critical interest to API's membership. API urges Congress to use the reauthorization process as means for ensuring that the cross-border application of the CFTC's rules and regulations (i) does not place U.S. companies at a disadvantage when transacting abroad and (ii) does not raise unnecessary barriers for non-U.S. companies seeking to trade in U.S. markets. Specifically, Congress should direct the CFTC to allow U.S. persons and their affiliates to comply with transaction-level regulation of the relevant nation when doing business abroad, as long as such regulations are consistent with the G-20's derivatives reform principles. In addition, non-U.S. persons that transact in the U.S. markets, to the extent applicable, should be permitted to comply with their home country's entity-level regulations as long as such regulations are consistent with the G-20's derivatives reform principles. Finally, given the significance of the CFTC's approach to cross-border regulation of derivatives markets, Congress should require the Commission to publish any cross-border guidance as part of an actual rulemaking process so a public notice and comment period is permitted and a proper cost-benefit analysis is performed.

I. SWAPS BETWEEN AFFILIATES IN THE SAME CORPORATE FAMILY SHOULD BE EXEMPT FROM CFTC REGULATION.

Currently, the final and proposed rules issued by the CFTC generally treat inter-affiliate swaps in the same manner as swaps transacted between unaffiliated third-parties. Consequently, under certain circumstances, companies transacting swaps between affiliates must report swaps to a swap data repository or the CFTC (as applicable). In addition, companies must submit such swaps to central clearing unless the end-user hedging exception set forth in CEA Section 2(h)(7) applies or complex criteria for the inter-affiliate clearing exception issued by the CFTC recently are met. The CFTC has provided relief in the form of no-action letters, but the no-action letters do not provide adequate relief in many circumstances. Because these regulations impose significant costs upon end-users and inter-affiliate swaps have little to no impact on swap markets, API urges Congress to amend the CEA and exempt swaps between affiliates within the same corporate enterprise – whether directly, indirectly, wholly or partially owned – from CFTC regulation.

If you have any questions regarding this letter, or if we can be of further assistance, please contact Shane Skelton at (202) 682-8172 or skeltons@api.org

Respectfully submitted,

/s/Shane Skelton
Policy Advisor
American Petroleum Institute

American Public Power Association

LPPC

May 1, 2013

The Honorable Debbie Stabenow
Chairwoman
Committee on Agriculture, Nutrition and Forestry
United States Senate
Washington, D.C. 20510

The Honorable Thad Cochran
Ranking Member
Committee on Agriculture, Nutrition and Forestry
United States Senate
Washington, D.C. 20510

Dear Chairwoman Stabenow and Ranking Member Cochran:

As the Senate Agriculture Committee begins consideration of legislation to reauthorize the Commodity Futures Trading Commission, the American Public Power Association (APPA) and Large Public Power Council (LPPC) urge you to consider the effect of amendments made to the Commodity Exchange Act by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) on public power utilities.[1]

APPA is the national service organization representing the interests of over 2,000 municipal and other state- and locally-owned, not-for-profit electric utilities throughout the United States (all but Hawaii). Collectively, these public power utilities deliver electricity to one of every seven electricity customers in the United States (approximately 47 million people), serving some of the nation's largest cities. However, the vast majority of APPA's members serve communities with populations of 10,000 people or less.

LPPC is the national service organization comprised of 26 of the nation's largest public power utilities. LPPC member utilities own and operate more than 86,000 megawatts of generation capacity and over 35,000 circuit miles of high voltage transmission lines. Together, LPPC members control 90% of the public-agency-owned, but non-federal, transmission investment in the nation.

Public Power Utilities and the Dodd-Frank Act

Passed by Congress in the wake of the 2007 and 2008 financial crisis, the Dodd-Frank Act required the Commodity Futures Trading Commission (CFTC) to provide comprehensive regulations for the swaps marketplace. Specifically, the Dodd-Frank Act requires swap dealers and major swap participants to register with the CFTC and meet capital, margin, and reporting and recordkeeping requirements, as well as to comply with rigorous business conduct and documentation standards.

The Dodd-Frank Act provides additional standards for swap dealers or major swap participants advising or entering into swaps with including public power utilities, and other government

[1] "Public power" is not defined in the law, but generally refers to government-owned utilities. This is distinguished from a "public utility" which generally refers to an investor-owned utility, as under the Public Utility Holding Company Act of 1935 and the Federal Power Act.

entities (referred to under the statute as "special entities"). For a swap dealer acting as an advisor to a special entity, the law states that the swap dealer shall have a duty to act in the best interests of the special entity.[2] For swap dealers or major swap participants entering into swaps with special entities, the law states that these dealers and swap participants must comply with rules set by the CFTC, requiring special entities to have a qualified independent representative before trading with a swap dealer or major swap participant.[3]

Also, in part to address concerns that the legislation would force too many entities into this more stringent regime, the Dodd-Frank Act included a "*de minimis* exception" to the definition of a swap dealer.[4]

APPA and LPPC support the goals of the Dodd-Frank Act and have worked closely with the CFTC and other interested parties to improve its implementation, particularly related to regulations affecting "end users" – that is, nonfinancial parties that enter into swaps to hedge or mitigate their commercial risks. APPA members are "end users." Dozens of new regulations affect our members' businesses, and APPA and a coalition of not-for-profit electric utilities have submitted formal comments on 17 specific regulations from the CFTC and Securities and Exchange Commission (SEC) related to implementation of the Dodd-Frank Act.

One such instance is the rule defining swap-dealer,[5] which became final on July 23, 2012. Swap dealer registration regulations went into effect on October 12, 2012, at which time entities were required to begin counting their "swap dealing" activities. Those with dealing activity in excess of the *de minimis* thresholds had to register as swap dealers by December 31, 2012. However, the CFTC issued several no-action letters that allow swap dealers to delay their compliance with most of the business conduct and documentation standards until July 2013.

As written, the swap-dealer definition will substantially hinder government-owned utilities' ability to hedge against operational risks. These utilities have no shareholders, so the costs imposed by this regulatory decision will be borne by only one group: our members' customers.

In December 2010, the CFTC jointly with the SEC issued a proposed rule to define the term "swap dealer," including (as required by the statute) an exception from the swap-dealer designation for those entities that engage in a *de minimis* quantity of swap dealing.

In the proposed rule, the CFTC proposed two separate *de minimis* thresholds relating to the dollar quantity of swaps: $100 million annually for an entity's total swap-dealing activity; and, $25 million annually for an entity's swap-dealing activity with special entities, including, as noted above, public power, public gas, and federal utilities (government-owned utilities).

In February 2011, the Not-For-Profit Electric End User Group (NFP EEU)—which includes APPA and LPPC —filed comments on the proposed swap dealer rule. The comments

[2] 7 USC § 6s(h)(4).

[3] 7 USC § 6s(h)(5).

[4] 7 USC § 1a(49)(D).

[5] CFTC Regulation 1.3(ggg)(4); see 77 Fed. Reg. 30596, at 30744.

recommended that the CFTC substantially increase the *de minimis* threshold both for total swaps and for swaps with special entities.

A final swap dealer rule was approved by the CFTC on April 18, 2012, and was published in the *Federal Register* on May 23, 2012. The final rule greatly increased the overall *de minimis* threshold from the proposed rule, raising it from $100 million to $3 billion. During an initial phase-in period, this threshold will be $8 billion. But, the final rule did not change the proposed rule's $25 million sub-threshold for swap-dealing activities with special entities. Thus, the disparity between the two thresholds is now substantially greater. This $25 million sub-threshold is smaller still when you consider that it is the aggregate of a swap partner's transactions with all special entities during any 12-month period.[6]

As a result, nonfinancial entities (such as natural gas producers, independent generators, and investor-owned utility companies) that do not want to be swap dealers will severely limit their swap-dealing activities with government-owned utilities to avoid exceeding the $25 million threshold.

Why Hedging Is Necessary

Government-owned utilities depend on nonfinancial commodity transactions, trade options, and "swaps," as well as the futures markets, to hedge commercial risks that arise from their utility facilities, operations, and public service obligations. Together, nonfinancial commodity markets play a central role in the ability of government-owned utilities to secure electric energy, fuel for generation, and natural gas supplies for delivery to consumers at reasonable and stable prices.

Specifically, many government-owned utilities purchase firm electric energy, fuel and natural gas supplies in the physical delivery markets (in the "cash" or "spot" or "forward" markets) at prevailing and fluctuating market prices, and enter into bilateral, financially-settled nonfinancial commodity swaps with customized terms to hedge the unique operational risks to which many government-owned utilities are subject. Additionally, many government-owned utilities have traditionally used the swaps and futures products to hedge their excess electrical generation capacity, thus providing revenue and rate certainty to their customer/owners. In hedging, mitigating or managing the commercial risks of their utility facilities' operations or public service obligations, government-owned utilities are engaged in commercial risk management activities that are no different from the operations-related hedging of an investor-owned utility or an electric cooperative located in the same geographic region.

Why Nonfinancial Counterparties Are Necessary

Electric power touches virtually every home and business in the United States. This near universality gives a false appearance of homogeneity. It is important to remember that what is being delivered, either power or fuel to provide power, is a physical commodity, e.g., electricity, coal, natural gas, and the like. Ownership of a stock can be transferred coast to coast with a click of a button, but electricity must be delivered to the place it is to be used. Further, storage of

[6] By way of reference a single, one-year 100 MW swap could have a roughly $25 million notional value. One-hundred MWs of power is enough to serve the average demand of approximately 75,000 residential customers.

electricity for future use, unlike other commodities such as gasoline, grain, coffee, etc. is not currently viable and thus electricity must be produced at the time it is used.

Each regional geographic market has a somewhat different set of demands driven by climate, weather, population, and industrial activity, among other factors. Each regional geographic market also has a somewhat different group of financial entity counterparties and nonfinancial entity counterparties available to meet these demands and thus able to enter into utility operations-related swaps needed for hedging price and supply risks. For example, a large merchant electric generation station in western Alabama might be available as a nonfinancial counterparty for a swap transaction to provide electricity to a specific site in Alabama. But that same entity would not necessarily be able to offer the electricity in Oregon, and so would not be able to help an Oregon-based utility hedge its risks. Further, owners of electrical generation facilities and distribution utilities, whether investor-owned utilities, cooperative utilities, merchant generation companies, or government-owned utilities, operate in their geographical proximity and, as they balance their generation to meet changing demands on an hour-to-hour basis, are the most likely trading counterparties in their regions. These regional market participants, unlike financial entities, have a vested interest in maintaining the reliability of the electric grid and ensuring that sufficient liquidity exists to manage their operations.

Because there are a limited number of counterparties for any particular operations-related swap sought by a utility, each financial and nonfinancial swap counterparty brings important market liquidity and diversity: The greater the number of counterparties, the greater the price competition. Conversely, reduced price competition necessarily increases prices.

Government-Owned Utilities' Petition for Rulemaking

On July 12, 2012, APPA, LPPC, the American Public Gas Association (APGA), the Transmission Access Policy Study Group (TAPS), and the Bonneville Power Administration (BPA), filed with the CFTC a "Petition for Rulemaking to Amend CFTC Regulation 1.3(ggg)(4)." The petition requests that the CFTC amend its swap-dealer rule to exclude utility special entities' utility operations-related swap transactions from counting towards the special-entity threshold. This amendment to the swap-dealer rule would allow a producer, utility company, or other nonfinancial entity to enter into energy swaps with government-owned utilities without danger of being required to register as a "swap dealer" solely because of its dealings with government-owned utilities.

Specifically, the petition asks for a narrow exclusion:

- A government-owned utility's swaps related to utility operations would not count towards the special entity *de minimis* threshold, but would count towards the total *de minimis* threshold.

- Utility operations-related swaps are those entered into to hedge commercial risks intrinsically related to the utility's electric or natural gas facilities or operations, or to the utility's supply of natural gas or electricity to other utility special entities, or to its public service obligations to deliver electric energy or natural gas service to utility customers. For example, these would include swap transactions related to the generation, production, purchase, sale, or transportation of electric energy or natural gas, or related to fuel supply of electric generating facilities.

- Utility operations-related swaps do not include interest rate swaps. Those swaps would remain subject to the $25 million special entity sub-threshold.

CFTC "No Action" Letter

The CFTC released on October 12, 2012, a no-action letter relating to the $25 million special entity sub-threshold. The letter allows a counterparty to deal in up to $800 million in swaps with government-owned utilities without being required to register as a swap dealer. As the CFTC explained in that letter, the $800 million is derived from a comment letter endorsed by the NFP EEU group suggesting that the special entity sub-threshold be set at 1/10th that of the overall swap dealer threshold.

The no-action letter, however, also included a number of additional limitations on a counterparty wishing to take advantage of the relief provided by the letter. Specifically, under the terms of the CFTC's no-action letter, the $800 million threshold applies only:

- If the special entity that is a party to the swap is using the swap to hedge a "physical position;"

- If the counterparty is not a "financial entity" as defined in the Commodity Exchange Act;

- If the swap is related to an exempt commodity in which both parties transact as part of the "normal course of their physical energy businesses;" and

- If a counterparty wanting to take advantage of the relief provided by the no-action letter files with the CFTC a notice that it is making use of the relief and provides, by December 31 (and quarterly thereafter), a list of each utility special entity with which it has entered into swaps and the total gross notional value of those swaps.

Certain counterparties have expressed concerns over one or more of the conditions imposed in the no-action letter, but it could also be that counterparties, in general, are not willing to spend the time and money to create a separate compliance process and adjust their policies and procedures in order to facilitate transactions with the small segment of any particular regional market that utility special entities represent. This is especially likely now as counterparties are focused on implementing compliance programs dealing with the whole range of Dodd-Frank requirements. Finally, there is the overarching issue that the no-action letter, by definition, is temporary and can be revised or revoked without any of the steps of a formal rulemaking process.

Whatever the reason, the no-action letter has failed to provide nonfinancial counterparties with the assurances they need to enter into swap transactions with our members.

A November 19, 2012, letter to the CFTC explaining this outcome has failed to produce any further action from the CFTC, though several commissioners have indicated that they believe that relief is appropriate.[7] They have also indicated that absent action by the CFTC, legislation to address this issue directly would be appropriate.[8]

The Public Power Risk Management Act

On March 11, 2013, the Public Power Risk Manage Act of 2013 (H.R. 1038) was introduced by Congressman Doug LaMalfa (R-CA), a member of the House Committee on Agriculture, with fellow committee members Jim Costa (D-CA), Jeff Denham (R-CA), and John Garamendi (D-CA), along with House Financial Services Committee member Blaine Luetkemeyer (R-MO). As of May 1, 2013, the legislation had 35 cosponsors.

The legislation largely mirrors the intent and effect of the NFP EEU petition to the CFTC, providing narrowly targeted relief for operations-related swaps for government-owned utilities. Specifically, the legislation would provide that the CFTC, in making a determination to exempt a swap dealer under the *de minimis* exception, shall treat a utility operations-related swap with a utility special entity the same as a utility operations-related swaps with any entity that is not a special entity.

Under the current threshold/sub-threshold regulatory regime adopted by the CFTC, this would mean that utility operations-related swaps with a government-owned power or natural gas utility would not be counted in calculating whether swap dealing activity exceeded the $25 million special entity *de minimis* threshold, but would be counted in calculating whether swap dealing activity exceeded the $8 billion *de minimis* threshold.

The legislation carefully defines which entities would qualify as a "utility special entity." It also specifically defines the types of swaps that could and could not be considered a "utility operations-related swap." For example, the legislation specifically prohibits interest, credit, equity, and currency swaps from being considered as a utility operations-related swap. Likewise, except in relation to their use as a fuel, commodity swaps in metal, agricultural, crude oil, or gasoline would not qualify either.

Finally, the legislation also confirms that utility operations-related swaps are fully subject to swap reporting requirements.

When implemented, this legislation should provide the certainty to nonfinancial entities that they can enter into swap transactions with government-owned utilities without fear of being deemed a swap dealer. It truly levels the playing field. And, it does nothing to otherwise alter the CFTC's implementation of the Dodd-Frank Act.

We wish the legislation were not necessary, but given the realities we face and the ongoing damage being done under the current rules, we urgently request that you support a similar

[7] Statement of Commissioner Bart Chilton, Commodity Futures Trading Commission, "The End User Bill of Rights" (http://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement040313) (stating that "Public power end-users using swaps to hedge commercial risk should have the same access to risk management markets as privately-owned utilities.").

[8] *Ibid.* (stating that action should be taken "preferably through regulatory relief." However, in comments to reporters Commissioner Chilton stated that absent regulatory relief, legislation would be appropriate).

<u>legislative fix, either as a standalone bill or as part of the Committee's consideration of the CFTC reauthorization.</u>

<u>Conclusion</u>

In conclusion, the protections the CFTC is trying to afford through the $25 million special entity sub-threshold are not needed for utility operations-related swaps entered into by government-owned utilities.

Government-owned utilities are well-versed in the markets in which they are hedging their risks and rely on these swaps solely to manage price and operational risks.

More importantly, the assumption that financial firms will be able to replace all the swaps offered currently by our nonfinancial swap partners reflects a dangerous misunderstanding of how electricity is delivered and an indifference to the price Wall Street will impose in the absence of adequate competition.

In sum, a failure to allow the narrow relief provided under the Public Power Risk Management Act or similar legislation will limit our members' ability to hedge against risks and lead to increased risk and costs to the ratepayers they serve.

Thank you again for this opportunity to present our views. Both APPA and LPPC and our members would be more than happy to answer any questions you might have.

Sincerely,

Mark Crisson
President & CEO
American Public Power Association
1875 Connecticut Ave. NW
Washington, DC 20009

Michele Mandell

Missy Mandell
Executive Director
Large Public Power Council
P.O. Box 34321
Washington, DC 20043

AMERICANS
FOR FINANCIAL REFORM
ACCOUNTABILITY • FAIRNESS • SECURITY

Americans for Financial Reform
1629 K St NW, 10th Floor, Washington, DC, 20006
202.466.1885

May 3, 2013

Re: Reauthorization of the Commodity Futures Trading Commission (CFTC)

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

Dear Chairwoman Stabenow and Ranking Member:

Americans for Financial Reform ("AFR") appreciates the invitation to provide recommendations on the reauthorization of the Commodity Futures Trading Commission (CFTC). We thank you for your commitment to an open reauthorization process and for reaching out to our coalition for input.

AFR is a coalition of more than 250 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups along with prominent independent experts.

Background

The CFTC was reauthorized through 2013 in the Food, Conservation and Energy Act of 2008.[1] This legislation provided the CFTC with substantial additional authority over the futures, options and swaps markets, including measures to close the so-called 'Enron loophole' through expanding CFTC oversight to "price discovery contracts" on previously unregulated electronic trading platforms. The 2008 reauthorization also strengthened antifraud prohibitions and increased civil monetary penalties for manipulation or attempted manipulation of commodity markets from $500,000 to $1 million per violation

However, most significant changes in the CFTC's authority since it was last reauthorized occurred in Title VII of the Dodd-Frank Act (the 'DFA'). This legislation instituted the most comprehensive changes in the Commodity and Exchange Act (CEA) since the Great Depression. The catastrophic events of the financial crisis of 2008-2009 clearly revealed the need for

[1] Pub.L.110-246

comprehensive regulation of the over-the-counter swaps market. The DFA granted the CFTC authority to regulate the great majority of the over-the-counter swaps market (all swaps with the exception of credit default swaps based on a single security or a narrow index of securities). This change added approximately $300 trillion in notional derivatives markets to the CFTC's supervision responsibilities – an eight-fold increase in the size of the market the CFTC must supervise. In addition, the DFA granted the CFTC important new anti-manipulation authority and outlined a position limits regime to prevent excessive speculation in the commodity markets.

Below, we outline several initial recommendations for the committee to examine as it drafts a reauthorization bill. AFR would appreciate the opportunity to amend or expand upon this list in the future, both to provide additional detail and potentially to outline new recommendations. Also, these recommendations do not preclude the submission of supplemental recommendations by individual AFR members or their affiliates.

Funding of the CFTC

While the Dodd-Frank Act increased the responsibilities of the CFTC greatly, it did not create self-funding mechanisms for the agency that would guarantee the resources needed to execute these responsibilities. The CFTC is the only significant financial regulator that is not self-funded, and is also by far the smallest of the significant financial regulators. The CFTC is currently funded at approximately $200 million annually, more than 35 percent below the requested level of $315 million. This is a level that is inadequate to perform the core monitoring, regulatory, and enforcement functions of the agency. The request of $315 million is minuscule in comparison to the roughly $37 trillion U.S. futures market and $300 trillion U.S. swaps market supervised by the CFTC. A fee sufficient to automatically raise this amount would hardly be noticeable by market participants, and would be proportionally smaller than the SEC's Section 31 fees.

The CFTC's staffing level declined precipitously during the years prior to the financial crisis, even though commodity futures markets were growing rapidly and unregulated swaps markets played a critical role in triggering a collapse of the financial system. Although staffing levels have grown somewhat since 2008, the CFTC's current staffing level is just seven percent higher than it was 20 years ago. But the combination of a five-fold increase in the notional size of the commodity futures market over the past two decades and the addition of the previously unregulated swaps markets means that the total size of the markets overseen by the agency have grown by almost forty times over that period.

AFR strongly supports the President's recommendation to authorize the CFTC to charge user fees to raise its full level of funding. We support measures to make the agency fully self-funding, as is the case for all of the banking agencies and the Consumer Financial Protection Bureau. This would permanently guarantee the agency adequate resources to carry out its mission. As shown by the decline in agency staffing during the years prior to the financial crisis even as the regulated market grew, the CFTC's underfunding problem is chronic and requires a fundamental structural solution. A fee based arrangement would mean that CFTC funding would grow automatically with the size of the markets supervised.

Manipulation & Excessive Speculation

Speculative position limits are important in preserving the overall integrity of the commodity markets, protecting consumers from inflation in commodity prices caused by market manipulation and excessive speculation, and preserving the ability of real economy companies to use commodity derivatives for bona fide hedging without inflated prices due to excessive volatility. 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 on Appeal. Our coalition strongly supports the immediate implementation of mandatory position limits and believes that the intent of Congress was clear and unambiguous.

However, even when the October 18th final rule is implemented, there are serious doubts about whether the Commission's actions in that rule went far enough in addressing the harmful effects of excessive speculation. Specifically, AFR feels that the October 18th rule is overly focused on market manipulation by individual traders and is not oriented to addressing the harmful market dynamics created by excessive levels of speculation in the aggregate. Furthermore, we are concerned that individual position limits set forth by the rule are too high, and that the rule only requires periodic review of established limits.

We believe that a more 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 of trader. While the CFTC appears to have the statutory authority to require such speculative class limits under current law, they have chosen not to do so. Yet limits on aggregate speculation are necessary to address all the market effects of excessive speculative interest, which go well beyond the possibility of market manipulation by an individual speculator. In the forthcoming CFTC Reauthorization Act, the committee should require the CFTC to establish class-specific limits on aggregate speculation.

Penalties

Current law allows fines of up to $1 million per violation for manipulation or attempted manipulation and $140,000 for other violations under the Commodity Exchange Act.[2] The definition of 'per violation' is open to judicial interpretation. While the amount of these fines vary with the number of violations found by the court in each case, they are generally 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.

The committee should increase fines and penalties as appropriate in the CFTC Reauthorization Act in order to more effectively deter unlawful behavior. Given the potentially enormous profits that can be earned through manipulation of these markets, effective deterrence may require stronger steps than simply raising the maximum penalty for a single violation. The Committee

[2] 7 U.S.C. §13

should also grant the CFTC the authority to escalate penalty levels for repeated egregious or major violations, and should ensure that the CFTC has the ability to ban entities or individuals from future participation in the markets if they engage in repeated egregious behavior.

Additionally, the CFTC is currently restrained by the blanket five-year Statute of Limitations (SOL), which restricts the ability of Commissioners to prosecute violations of the CEA, including cases of fraud and manipulation. The existing five-year SOL challenges the CFTC to prosecute cases despite a limited budget and personnel and the increasing complexity of the markets it regulates. Therefore, the committee should extend the SOL for the CFTC to a minimum of 10 years.

Proposed House Legislation

On March 20, 2013, the House Agriculture Committee approved legislation that would amend the Commodity Exchange Act and, in some cases, intervene in ongoing CFTC rulemakings. Our coalition has taken a position against most of this legislation, which is now pending consideration in the House Financial Services Committee. We understand that some members of Congress, trade associations and special interest groups are recommending one or more of this legislation be included as part of CFTC reauthorization. Below you will find thoughts of our coalition on this legislation.

H.R.634, the Business Risk Mitigation and Price Stabilization Act – H.R.634 would exempt from capital and margin requirements any swap which qualifies for the commercial end user exemption from clearing. AFR believes this legislation is unnecessary given the action of regulators to exempt the vast majority of such 'end user' swaps from margin by rule. Furthermore, while this legislation leaves in place prudential authorities to require capital and margin for end user swaps at bank swap dealers, it removes the only statutory authority for the CFTC to require end user margin at CFTC-regulated non-banks. As a targeted use of this authority could prove important in responding to future cases of market disruption, this legislation is potentially harmful as well as unnecessary. AFR opposes this legislation.

H.R.677, the Inter-affiliate Swap Clarification Act – H.R.677 would exempt inter-affiliate swaps from the definition of 'swap' under Dodd-Frank for all purposes except reporting. Furthermore, the legislation defines 'affiliate' very loosely, as any two entities that report their finances on a consolidated basis. Such consolidated reporting does not even require common majority ownership. The combination of a very loose definition of 'affiliate' and a radical narrowing of CFTC jurisdiction for such swaps makes this legislation a significant threat to effective swaps regulation. Furthermore, the CFTC has already used its existing authority to finalize a generous exemption for the great majority of inter-affiliate swaps from clearing and margin requirements, demonstrating that this legislation is unnecessary to accomplish legitimate goals of an appropriate exemption for genuine inter-affiliate swaps. AFR strongly opposes this legislation.

H.R.742, the Swap Data Repository & Clearinghouse Indemnification Correction Act –
H.R.742 would remove the indemnification provisions from Sections 728 and 763 of the Dodd-Frank Act to allow data sharing for swaps between U.S. and foreign regulators. AFR does not

oppose this legislation as is it is a non-controversial technical correction that could improve regulatory effectiveness.

H.R.1003 (no title) – H.R.1003 would repeal existing cost-benefit requirements under the CEA and requires the CFTC to conduct more expansive and comprehensive analyses before approving regulations or orders. While comprehensive cost-benefit considerations and analyses of potential burdens on market participants should always be considered by any federal regulator, adequate requirements already exist in the CEA. We believe the legislation is politically-motivated with the intent of slowing down important new derivative market regulations even further than already existing delays, which are unacceptable. AFR strongly opposes this legislation.

H.R. 1256, the Swaps Jurisdiction Certainty Act – H.R.1256 would require the SEC and CFTC to jointly issue rules relating to swaps transacted between U.S. and non-U.S. persons and exempts a non-U.S. person in compliance with the swaps regulatory requirements of a G20 member nation from U.S. swaps requirements 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 and could delay or undermine those efforts. Even more important, the substantial new hurdles it creates to effective regulation of swaps conducted off-shore by U.S. entities means that it would create an off-shore loophole that could allow systemically risk entities or financial institutions to evade U.S. regulation. Proper regulation of foreign subsidiaries of U.S. financial institutions is essential to effective derivatives oversight. AFR strongly opposes this legislation.

Support For the Full Implementation of Dodd-Frank

The legislative proposals above have in common that they seek to impede CFTC implementation of the new derivatives framework in Title VII of the Dodd-Frank Act. Despite its lack of funding, the CFTC has been a leader in Dodd-Frank implementation, and has finalized a greater proportion of its assigned rules than any other financial regulatory agency.[3]

Title VII of the Dodd-Frank Act is a common-sense solution to derivatives regulation that relies on market tested tools such as exchange trading, clearing, and entity risk management. Furthermore, ample regulatory discretion is provided to the CFTC in determining exactly which entities and which types of instruments are subjected to these requirements. Indeed, the CFTC has been highly responsive to industry in providing exemptions for small banks, co-operatives, end users, commercial hedgers, dealers with notional swaps volume below $8 billion, and numerous other situations as well. Given the moderate and measured nature of Title VII and the substantial regulatory discretion permitted to the CFTC to address any technical issues that may arise, statutory intervention that results in impeding CFTC implementation of Dodd-Frank is completely inappropriate.

[3] See David-Polk, "Dodd Frank Progress Report", May 2013.

Other Areas -- High Frequency Trading And Self Regulatory Organizations

AFR views the rapid growth of high frequency trading (HFT) as a significant threat to the structure and legitimate purposes of the commodity markets. According to the Tabb Group consultancy, HFT now accounts for over 60 percent of futures market volumes, up from 47 percent five years ago. Evidence is mounting that predatory HFT, rather than improving genuine market liquidity, increase volatility, impedes market functioning, and creates negative externalities for other traders.[4] While the CFTC has statutory authority to regulate HFT, progress in this area has been slow. Adequate data is still lacking and even the definitional decisions needed to properly define the scope of the problem have not taken place. AFR does not have specific policy recommendations concerning HFT at this time, but may submit them in the future. However, we urge the Committee's attention to this important issue. The Committee should seek out opportunities to facilitate and speed CFTC action in this area.

AFR would also like to join Better Markets in urging attention to the problem of excessive reliance on self-regulatory organizations in oversight of the futures markets. As detailed in the Better Markets letter, recent years have seen repeated failures by self-regulatory exchanges such as CME and ICE and associations such as the National Futures Association to properly oversee member organizations and the markets in general. The problem of over-reliance on self-regulatory agencies is fundamentally related to the issue of CFTC underfunding, which as stated above should be addressed through fee-based self-funding. However, even apart from the funding issue, the Committee must reexamine the excessive role of self-regulation in futures markets. As a significant volume of the swaps market could potentially move to the futures markets under 'futurization' initiatives, the need to do so is becoming more pressing.

Conclusion

Again, we appreciate the opportunity to provide input to the committee as it begins its work to draft legislation to reauthorize the CFTC. AFR and its member organizations stand ready to provide additional input to the committee as it continues its work. Should you have any questions, please contact Marcus Stanley, AFR's Policy Director, at (202) 466-3672 or marcus@ourfinancialsecurity.org.

[4] Kirilenko, Andrei A. and Lo, Andrew W., Moore's Law vs. Murphy's Law: Algorithmic Trading and Its Discontents (March 19, 2013). Available at SSRN: http://ssrn.com/abstract=2235963

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- American Income Life Insurance
- American Sustainable Business Council
- Americans for Democratic Action, Inc
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions
- Housing Counseling Services

- Home Defender's League
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NAACP
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Council of Women's Organizations
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Resource Center
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Urban League
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS

- U.S. Public Interest Research Group
- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

List of State and Local Affiliates

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA

- Empire Justice Center NY
- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M

- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

Small Businesses

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Pheonix AZ
- The Holographic Repatterning Institute at Austin
- UNET

BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

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.

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

---

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

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.

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

[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.

---

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

---

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

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.
>
> 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.

---

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

---

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.

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.

CONCLUSION

We hope you find these comments useful.

Sincerely,

Dennis M. Kelleher
President & CEO

David Frenk
Director of Research

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

dkelleher@bettermarkets.com
dfrenk@bettermarkets.com

www.bettermarkets.com

CME Group

May 1, 2013

The Honorable Debbie Stabenow
Chairwoman
Committee on Agriculture, Nutrition and Forestry
United States Senate
328A Russell Senate Office Building
Washington, D.C. 20S10

The Honorable Thad Cochran
Ranking Member
Committee on Agriculture, Nutrition and Forestry
United States Senate
328A Russell Senate Office Building
Washington, D.C. 20S10

Dear Chairwoman Stabenow and Ranking Member Cochran:

Thank you for the opportunity to share CME Group's's[1] recommendations relating to the reauthorization of the Commodity Futures Trading Commission ("CFTC"). We agree that this reauthorization comes during an important and challenging time for the industry as businesses that are dependent on the financial services sector for pricing information, hedging and other forms of risk mitigation are being hit by major costs in trying to adapt to new regulatory systems promulgated by U.S. and foreign regulators. We applaud your leadership in ensuring that the CFTC focuses its efforts on enhancing the safety and soundness of derivatives trading and clearing markets, making certain that the massive set of new regulations are both internally consistent and consistent with the Dodd-Frank Act ("DFA"), evaluating the costs and benefits of this new regulatory regime, and preserving the U.S. competitive stance in the global financial marketplace.

Our recommendations to the Committee focus on the following primary areas of concern: Implementation of the DFA, which unfortunately has led to confusion and unwarranted expense for

[1] CME Group Inc. is the holding company for four exchanges, CME, the Board of Trade of the City of Chicago Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges"). The CME Group Exchanges offer a wide range of benchmark products across all major asset classes, including derivatives based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. The CME Group Exchanges serve the hedging, risk management, and trading needs of our global customer base by facilitating transactions through the CME Group Globex electronic trading platform, our open outcry trading facilities in New York and Chicago, and through privately negotiated transactions subject to exchange rules.

market participants; evolution of the derivatives markets post DFA and misplaced concerns regarding "futurization"; appropriate funding of the agency; and efforts to strengthen customer protection and confidence in the derivatives markets post MF Global and Peregrine.

DFA Rulemaking and Implementation

The CFTC sought public comment over two years ago regarding the logical sequencing of DFA rules. Despite substantial public comment, the agency has implemented rules in an illogical and at times haphazard manner, leading to unnecessary cost and confusion for market participants. For example, the CFTC adopted many substantive rules before deciding what a swap is, who is a U.S. Person, and even who must register as a swap dealer. Compounding the unnatural flow of rulemakings, much of the rule set adopted by the CFTC was not – and still is not – clear. Through these two factors, the CFTC rules have chilled activity in certain markets and stymied businesses that rely on derivative markets to manage risk.

Throughout this process, the Commission has also developed a habit of waiting until the last minute to provide no-action or delayed compliance relief for market participants. The relief is welcome, but the timing is very disruptive to our customers that are making every effort to comply with the CFTC's new rules. Further, this approach has eroded the highly successful principles-based regulatory system at the heart of the Commodity Exchange Act ("CEA") in favor of a highly prescriptive regulatory model that was neither authorized nor envisioned by Congress when enacting DFA. We urge the Committee to ensure that the Commission implements DFA with greater clarity and guidance for market participants, including specifically with respect to the pending compliance, recordkeeping, and reporting requirements.

Evolution of the Derivatives Markets Post-DFA and "Futurization"

One of the fundamental purposes of the DFA was to respond to the financial crisis of 2008 by bringing regulatory oversight to the previously unregulated and opaque swaps market. The DFA accomplished this through two primary changes to the swaps market: (1) centralized clearing, to reduce systemic risk; and (2) reporting and trading on regulated platforms, to provide transparency. These policies mirror, in many ways, the regulatory structure under which the U.S. futures markets have operated for many decades.

Recently, some have claimed that marketplace choice between the trading of swaps versus futures is being driven by regulatory arbitrage, specifically with respect to margin rules that apply to swaps and futures. These claims about "futurization" fail to recognize that while many of the new swap regulations are similar to the regulations that are currently imposed on futures markets, swap regulations also reflect key differences between swaps and futures: (1) the different risk characteristics of futures and swaps and (2) the different manner in which futures and swaps have traded to date, which directly affects the risk characteristics of each.

Futures are standardized, cleared, and offered for trading in open and competitive centralized markets. Swaps have historically been more customized and predominantly traded bilaterally on OTC dealer markets. While under DFA certain swaps are required to be cleared and traded on a new type of regulated platform, the swap execution facility ("SEF"), SEFs are not required to offer open and competitive centralized markets. Also, unlike futures, there is an end-user exemption for swaps, which allows this important customer base to continue such trades OTC and uncleared.

Margin requirements permit the clearing house that is clearing a contract to mitigate the risk attendant to that specific contract. CFTC rules set a floor for the amount of initial margin that clearinghouses must collect. At CME Group, margin is determined by risk management policies and procedures designed to account for the actual risk profile of the product, not its label as a swap or a future. In fact, many of our futures products require initial margin in excess of the CFTC's regulatory floor.

It is consistent with the risk mitigation objectives of DFA to ensure that margin requirements be tailored to address the risk characteristics of different contracts. Market participants will continue to use both customizable swaps and standardized futures products. Innovation, competition and customer choice among well-regulated markets is not only a positive development for customers and the public as a whole, but is entirely consistent with the goals of DFA.

Agency Funding

With the passage of the DFA, the CFTC's jurisdiction greatly expanded to cover most of the previously unregulated OTC swap market. We support adequate funding for the CFTC, particularly in light of the agency's new jurisdictional reach. However, the manner by which the CFTC is funded does not need to change in order to ensure that it has the resources it needs to carry out its mission, including completing the rulemakings necessary to fully implement DFA. Further, the CFTC must be accountable for ensuring appropriated resources are not misallocated by, among other things, promulgating rules that are either unnecessary or not supported by an adequate cost benefit analysis.

The Administration's FY-2014 Budget proposes to increase the Commodity Futures Trading Commission's budget by $109 million to $315 million and to fund the entire amount with a "user fee" levied on futures and derivatives trades. Such a "user fee" will impose a $315 million per year transaction tax on market makers resulting in reduced liquidity, increased volatility, and less efficient use of U.S. futures markets. Less liquid and more volatile futures markets will result in increased costs for market participants. It will make it more difficult and expensive for farmers, ranchers, and other end users to hedge commodity price risk in the market. This will force farmers and other market participants to pass along these higher costs to consumers in the form of higher food prices. A $315 million tax on U.S. derivatives markets will also fail to actually collect the funds anticipated when market participants choose lower cost alternative jurisdictions and markets. For all of these reasons, Congress should reject a transaction tax to fund the CFTC.

Strengthening Customer Protection

Industry Safeguards

Customer protection is the cornerstone of the futures industry. In the wake of the unprecedented failures of MF Global and Peregrine Financial, CME Group, together with the National Futures Association ("NFA") and other U.S. futures exchanges have implemented new rules and procedures to strengthen the protection of customer property (and its investment) at the FCM through strict and regular reporting and on-line access to customers' balances at banks and other depositories. Timely access to this additional information is enabling us to better direct our regulatory resources at risk-based reviews of customer balances at clearing members and FCMs and their activity with respect to those balances. Our efforts to enhance our monitoring continue today through the use of an account balance aggregation tool supplied by a third-party service provider.

Moreover, the CFTC has recently proposed additional rules on customer protection that include provisions codifying these initiatives, which we strongly support. However, this rulemaking also seeks to fundamentally change the way in which the futures marketplace operates. The industry is conducting an impact analysis of these rules, as they could have a very significant impact on certain sectors in the marketplace, particularly smaller FCMs that serve the agricultural sector. We have urged the CFTC to allow the industry to complete this impact analysis before proceeding further with the rulemaking process.

Bankruptcy Code Improvements

In addition to the above-mentioned measures, we believe that Congress could further enhance customer protections through amendments to the Bankruptcy Code that would mitigate problems encountered in the MF Global bankruptcy. Potential amendments range from fundamental changes that would facilitate individual segregation of customer property to narrower revisions that would enhance a clearinghouse's ability to promptly transfer positions of non-defaulting customers, thereby reducing the risk that another customer's default or mishandling of customer funds by the FCM impairs customers' risk management activities. While amending the Bankruptcy Code is a significant undertaking, CME Group believes that modification to the bankruptcy regime in light of recent experience would benefit customers and the market as a whole.

Insurance for Futures

In the wake of MF Global and Peregrine Financial, some have advocated establishing an insurance scheme to protect futures customers. As we have testified before, such a fund would certainly boost confidence. However, any such proposal must be analyzed in light of the costs and potentially limited efficacy of such an approach due the extraordinarily large amount of funds held in U.S. segregation.

The futures industry, led by the Futures Industry Association ("FIA")[2], is researching various futures insurance mechanisms in order to provide a quantitative, data-based analysis that will enable policymakers and market participants to determine whether an insurance scheme would be viable.

Thank you again for the opportunity to share our recommendations relating to the CFTC's reauthorization as well as our views on a few of the significant issues facing our industry during this critical time of market evolution. As Congress considers reauthorization of the CFTC, we urge the Committee to continue its strong oversight of the CFTC's implementation of DFA and regulation of futures and derivatives markets. We look forward to working with the Committee during this process.

Sincerely,

Terrence A. Duffy

Terrence A. Duffy

[2] CME Group, the Institute for Financial Markets ("IFM") and the National Futures Association ("NFA") are also sponsoring the study.

Commodity Customer Coalition

Recommendations for the 2013 Re-Authorization of the Commodity Exchange Act

Presented to the Senate Committee on Agriculture, Nutrition & Forestry
May 2013

Written By:
James L. Koutoulas, Esq.
John L. Roe

Contents

SUMMARY

The Commodity Customer Coalition ("CCC") recommends that the Committee consider amending the Commodity Exchange Act ("CEA") as follows:

- Codify a first priority right for customers over all assets of an insolvent FCM's estate;
- Require that FCM residual financial interest in the customer segregated account be held in a separate but related account;
- Establish a specific criminal penalty for segregation violations;
- Increase the severity of civil monetary penalties for segregation violations;
- Provide for a Customer's Committee to represent the interests of customers in bankruptcy proceedings;
- Establish a separate account class for retail forex customers;
- Establish a separate account class for alternative segregation arrangements;
- Give the CFTC the authority to determine the appropriate liquidation proceeding for an insolvent FCM;
- Examine whether or not the CEA excludes the National Futures Association ("NFA") from using a portion of its member assessments for a customer protection fund; and
- Give the CFTC authority to bring criminal prosecutions.

The CCC still advocates for the creation of a customer protection fund or an insurance mechanism, though we do not believe such a fund should derive its authority from the CEA.

The CCC would like to thank the Chair and Ranking Member for the invitation to submit these recommendations. We would also like to thank Committee Staff for their consideration in this matter. We remain at the Committee's service.

CODIFYING CUSTOMER PRIORITY: SUBORDINATING ALL DEBT TO CUSTOMER CLAIMS

Bankruptcy proceedings surrounding recent FCM insolvencies have involved provisions across disparate legal authorities including: the Bankruptcy Code, the Commodity Exchange Act, and the CFTC's Part 190 Regulations. The complicated and interconnected relationships between these myriad authorities has obscured the original intent of Congress in granting "customers' claims first priority in the distribution of the estate" of bankrupt brokers.[1] As detailed in Senate Report No. 95-989, which accompanied the Bankruptcy Reform act of 1978:

> *A fundamental purpose of these provisions is to ensure that the property entrusted by customers to their brokers will not be subject to the risks of the broker's business and*

[1] Pub. L. 95-598, Senate Report No. 95-989.

will be available for disbursement to customers if the broker becomes bankrupt. As a result of section 765 (enacted as 766[h]), a customer need not trace any funds in order to avoid treatment as a general creditor as was required by the Seventh Circuit in In re Rosenbaum Grain Corporation.[2]

Yet Trustees and courts adjudicating insolvent FCMs have reached differing conclusions. 11 USC § 766 provides "that if a customer is not paid the full amount of such customer's allowed net equity claim from Customer Property, the unpaid portion of such claim is a claim entitled to distribution under section 726 of this title." This has led many to read that customers only have priority to all other claims with respect to the assets held by the debtor in the customer estate. Therefore, customer claims exceeding the value of the customer estate could potentially be treated as unsecured general creditors of debtor's estate property.

The Part 190 Regulations remedy this problem by broadening the definition of what constitutes Customer Property, so as to include FCM estate assets should property recovered for customers be insufficient to satisfy customers' claims. However, one court (in an order later vacated by settlement between parties) found that the CFTC exceeded its statutory authority by broadening the definition of "Customer Property" beyond its definition in Section 761 of Chapter 7 of the Bankruptcy Code. Although the CEA gives the CFTC the authority to determine what constitutes Customer Property (7 USC § 24), the Bankruptcy Code gives a more narrow definition of the term. In the 1999 bankruptcy of FCM Griffin Trading Company, the Northern District Court of Illinois held as follows:

The Court further concludes that the CFTC exceeded its statutory grant of rulemaking authority and that the provisions of 17 C.F.R. § 190.08(a)(1)(ii)(J) are invalid. Pursuant to the provisions of Subchapter IV of Chapter 7 of the Bankruptcy Code, any shortfall in customer property as defined in that Subchapter must be treated as a general unsecured claim.

Although this opinion was vacated, it is possible that another court could reach the same conclusion. There was an open question as to the priority of customers in the MF Global bankruptcy which was avoided by the recently approved liquidation plan in which creditors agreed to make the customer estate whole. There are two ongoing FCM liquidations in which Customer Property shortfalls will persist: Sentinel Management Group ("SMG") and Peregrine Financial Group ("PFGBest"). In either case, customers' claims not satisfied by the Customer Property pool could be treated as general creditor claims. This is clearly contrary to the objective Congress intended to achieve establishing protections for customers of commodity brokers.

Therefore, the CEA needs to be amended to clarify that customers of defunct FCMs have a first priority right over all creditors to estate assets of an insolvent FCM should a shortfall in the customer estate persists. Given that claim priorities are established in the Bankruptcy Code (**11 USC § 507**) and Customer Property maintains a more narrow definition within Chapter 7 (**11 USC § 761 (10)**), the most efficient means to establish a first-priority for customer claims within the framework of the CEA is to create a provision requiring all FCM creditors and affiliates to subordinate their debts and general creditor claims below customer claims.

---

[2] Pub. L. 95-598, Senate Report No. 95-989.

Since the Bankruptcy Code is beyond the purview of this Committee, care should be taken to establish a customer priority congruent with Title 11 provisions. A mechanism that the Bankruptcy Code contemplates which could help achieve this aim, without causing conflicts among statutes, is that of subordination of debt (**11 USC § 510**):

> *A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable non-bankruptcy law.*[3]

Requiring subordination of non-customer debts and claims with registered FCMs would establish a first-priority right for customers. Further, it would speed distributions of Customer Property by eliminating the need to reserve assets of the customer estate against the claims of a bankrupt FCM's holding company, affiliates or creditors. The SIPA Trustee managing the liquidation of MF Global, Inc. ("MFGI") faced the prospect of protracted litigation with representatives of creditors of MFGI's holding company as well as its affiliated entities. These affiliates entered large claims against MFGI's customer estate. The SIPA Trustee was therefore required to reserve hundreds of millions of dollars in Customer Property against a potential adversarial judgment resulting from these claims, drastically slowing the release of customer funds.

Affiliated entities of bankrupt FCMs should not be permitted to use the claims process as a negotiating ploy designed to pressure a Trustee by stalling distributions of customer funds. If the debt of creditors and affiliates were subordinated, there would be no cause to reserve property for such claims. Additionally, the substantial portions of an FCM's customer estate ensnared in an insolvency proceeding in a foreign jurisdiction would not impact recovery speed if subordination of those claims were the law. This can result in lengthy delays as foreign proceedings play out. Subordinating all debts to customers would free a trustee to use estate assets to make the customer estate whole, regardless of the outstanding claims on them. Moreover, such a subordination provision would benefit customers because large creditors would not be financially rewarded for turning a blind eye to inappropriate or risky FCM business practices. For example, subordination of all business-affiliate debts and claims below customer claims would incentivize large creditors, who often have significantly more insight and control over a FCM's operations than customers do, to perform due diligence on the FCMs internal controls and pay attention to a FCM's potential malfeasance. Significantly, subordination avoids the creation of a 'moral hazard' because it protects the sanctity of customer funds from being manipulated for creditor and/or insider benefit.

---

[3] 11 USC § 510

REQUIRE FCM RESIDUAL FINANCIAL INTEREST IN CUSTOMER SEGREGATED ACCOUNTS TO BE DEPOSITED IN A SEPARATE RELATED ACCOUNT

Although both the CEA and CFR prohibit comingling of FCM and customer funds, 17 CFR 1.23 permits FCMs to maintain a residual financial interest in their customer segregated account in any amount the FCM deems necessary in order to prevent customer accounts from "becoming under-segregated at any time." While this regulation and relevant sections of the CEA create a legal distinction between customer and FCM funds in customer segregated accounts, operationally these funds exist in the same accounts. They are for all practical purposes comingled.

This convenience has given rise to several issues related how an FCM uses and accounts for this residual interest. It gives plausible deniability to those FCMs that would attempt to use customer funds to meet the FCM's own liquidity needs. Plausible deniability arises from the fact that any withdrawal from a customer segregated account could be disguised as a withdrawal from firm excess if the firm provides an accompanying falsified segregation report. However, a more effective buffer could be created in a fashion that completely segregates firm excess and customer funds.

Specifically, firm residual financial interest should be placed in a sub-account linked to the customer segregated accounts so that it may continue to be used as a buffer for customer debits while remaining truly segregated from customer funds. This change in conjunction with the CFTC's recommendation for labeling of customer segregated accounts as such under a modification to Rule 1.20 helps counterparties, such as custodian banks, readily identify the true nature of funds. Had these two rules been in place prior to the collapse of MF Global, both MF Global and JP Morgan executives would have had a much more difficult time justifying the wire and receipt of customer funds, respectively, to satisfy margin calls arising from MF Global's proprietary trading activities.[4]

ESTABLISH SPECIFIC CRIMINAL PENALTIES FOR VIOLATIONS FOR MISAPPROPRIATION OF CUSTOMER FUNDS

Currently, criminal charges for segregation violations rely on federal prosecutors showing criminal intent as part of the conduct of a guilty party. 7 USC § 13 provides that it is a felony punishable by 10 years of imprisonment "to embezzle, steal, purloin or with criminal intent convert" Customer Property. Each of those crimes generally requires an intent to deprive an owner of his property. Requiring a demonstration of criminal intent has allowed bad actors to put forth defenses that their conduct was merely negligent or that they were simply unaware of the actions causing a shortfall in customer segregated accounts. For example, Jon Corzine asserted *"I never intended to break any rules"* in Congressional testimony. [5]

Because the principle of customer account segregation is the most important for protecting marketplace confidence, FCMs must maintain the integrity of the system at all costs. Thus, appropriate public policy to achieve such a goal must seriously deter FCMs from allowing breaches of segregation. The best way to do so is to remove the possibility that FCM executives can escape prosecution by pleading ignorance or negligence and enforce criminal penalties for segregation breaches without the need to prove intent. 7

---

[4] MFGI Trustee's *"First Investigative Report,"* page 23: *http://admin.epiq11.com/MFG/document/GetDocument.aspx?DocumentId=1753875*

[5] *"Corzine Defends Tenure, Puzzles Over Missing Funds,"* http://online.wsj.com/article/SB10001424052970203413304577085953794621344.html

USC § 13 should be amended so there is a strict liability for violations involving the transfer or conversion of Customer Property.

While the CCC would like to see a strict liability standard for infractions involving Customer Property, we do not wish to see those who are trying to comply punished for honest mistakes. Therefore there should be a standard of scale to ensure that violations which arise from honest mistakes are not criminally punished. In cases where there is a shortfall of Customer Property exceeds a firms excess net capital, there should be defined, criminal penalties should for any staff of an FCM who knew or should have known of the improper transfer of Customer Property, or those of any counterparty who receives such improperly transferred Customer Property.

INCREASE SEVERITY OF CIVIL MONETARY PENALTIES FOR SEGREGATION VIOLATIONS

Several major industry participants have violated segregation requirements and faced relatively minor penalties.

- See "*CFTC Sanctions J.P. Morgan Futures, Inc. $300,000 for Failing to Properly Segregate Customer Funds and Failing to Timely Report the Under-segregation to the CFTC,*" http://www.cftc.gov/PressRoom/PressReleases/pr5713-09;
- "*Cantor Fitzgerald Sanctioned $700,000 for Allowing Customer Funds to Become Under-Segregated,*" http://www.cftc.gov/PressRoom/PressReleases/pr6419-12;
- "*CFTC Orders Connecticut-based Interactive Brokers LLC, a Registered Futures Commission Merchant, to Pay a $225,000 Civil Monetary Penalty,*" http://www.cftc.gov/PressRoom/PressReleases/pr6560-13.

While the size of these fines seems large out of the context of a large financial institution, they are rounding errors when compared to the overall business activities of these firms, and their method of calculation seems to be almost completely arbitrary and inconsistent. When compared to each firm's Adjusted Net Capital as reported by the National Futures Association, it is clear that the fines are minuscule and do not serve as meaningful deterrents.

Firm Name	Adjusted Net Capital as of 2/28/2013	Fine Amount	Fine as % of ANC
JP Morgan	$13,063,109,297	$300,000	0.0023%
Cantor Fitzgerald	$228,216,093	$700,000	0.3067%
Interactive Brokers	$1,668,535,129	$250,000	0.0150%

Thus, rather than act as a deterrent, these fines are a minor cost of doing business which perversely creates an incentive for firms to maintain weak internal controls (and strong legal teams). In fact, many firms use rudimentary, manual Microsoft Excel spreadsheets to track their most important accounting functions,[6] and simply spend massive amounts on litigation to defend their conduct rather than investing

[6] *See "Solutions To Spreadsheet Risk Post JPM's London Whale,"* http://www.forbes.com/sites/tomgroenfeldt/2013/02/19/solutions-to-spreadsheet-risk-post-jpms-london-whale/

in infrastructure. "JPMorgan Chase noted in its annual report filed with regulators that it and its subsidiaries "are defendants or putative defendants in more than 10,000 legal proceedings, in the form of regulatory/government investigations as well as private, civil litigations."[7]

Furthermore, industry-wide practices indicate either a pervasive, cavalier attitude towards maintaining segregation or they reveal that the segregation rules are too difficult to follow. Cantor and Interactive Brokers were supposedly unaware that breaches had occurred for substantial lengths of time before finally self-reporting the violations. Also, the National Futures Association presided over multiple audits of PFGBest, Sentinel, and Interactive Brokers and did not identify a lapse in segregation in any of those three entities. How can we tell customers that their assets are protected if those charged with protecting their funds don't have the proper internal controls or audit procedures to even ascertain whether or not the funds are segregated?

Alternatively, a failure to segregate should be penalized by the greater of a $250,000 penalty, or 1% of adjusted net capital. Moreover, the CEA should be expanded to specifically convey personal responsibility to the principals of the FCM so that they may not escape punishment due to the insolvency of an FCM. Also, rather than such penalties being paid to the US Treasury, they should be distributed to customers until any shortfall in customer segregated accounts is cured.

ESTABLISH A STATUTORY PROVISION FOR A CUSTOMER COMMITTEE FOR DEBTOR FCMs

JPMorgan and Bank of America are two of the largest financial institutions in the US. While customers of MF Global and PFGBest had to scrape together donated funds and organize intermediaries like the CCC to represent them to the Court, two of the largest banks in the US were able to pay for their legal expenses relating to MF Global from the assets of their holding company's estate. As members of the Creditors' Committee, they can maximize the return to unsecured creditors at little or no expense to them. Customers of FCMs with parent companies in Chapter 11 proceedings should have a statutory right to form a Customers' Committee of the bankrupt parent, with similar rights as the Creditors' Committee. This will ensure that customers are afforded adequate legal representation without additional costs. Each customer account class identified in the CEA and CFR should receive proportional representation to the amount of assets their account class represents of the customer estate.

---

[7] *See "JPMorgan sees $4.5 billion legal hit,"* http://finance.fortune.cnn.com/2011/02/28/jpmorgan-sees-4-5-billion-legal-hit/

ESTABLISH A SEPARATE ACCOUNT CLASS FOR RETAIL FOREX CUSTOMERS

17 CFR 190.08 establishes that property held for the account of a customer segregated to a specific account class must be must be "allocated to the customer estate of the account class for which it is segregated or to which it is readily traceable". So within the customer estate, various account classes are owed property that can be traced directly to an account class. The CFR establishes the following account classes within the customer estate (17 CFR 190.01(a)), some of which derive their definition from the CEA:

- futures accounts, (7 USC § 6d) commonly referred to as Segregated Funds or 4d funds
- foreign futures accounts (17 CFR 30.7), commonly referred to as 30.7 or Secured Funds
- leverage accounts
- commodity option accounts
- delivery accounts (17 CFR 109.05 (a)(2))
- cleared OTC derivatives accounts

Many FCMs facilitate retail foreign exchange transactions ("retail forex") for customers. These transactions are non-exchange cleared over-the-counter ("OTC") transactions in which the FCM acts as counterparty to a retail forex trader's position. There are substantial differences between these transactions and exchange cleared futures and options trading, so much so that the NFA and CFTC have decided not to expand the entire regime governing futures trading to retail forex trading. As a result, customers who tender property to FCMs to engage in retail forex transactions may not be treated as a separate account class in FCM bankruptcies and they are not offered much in the way of collateral protections in the CFR or CEA. This means they could be treated as general creditors and their property distributed pro rata to other general creditors.

The insolvency of PFGBest demonstrates the need for retail forex customers to be given their own account class. Over $40 million of readily identifiable property of PFGBest's retail forex customers could be distributed pro rata to commodity customers as estate property or split amongst general creditors of the estate. In order to prevent these customers from losing their property in an inequitable distribution, the Committee should consider revising the CEA accordingly.

ESTABLISH A SEPARATE ACCOUNT CLASS FOR ALTERNATIVE SEGREGATION ARRANGEMENTS

Industry participants have begun testing alternative segregation arrangements in which Customer Property is held outside the control of an FCM. These arrangements typically involve another party acting as trustee for customer funds, such as a custodial bank. The bank manages the variation margin payment and collection between the exchange and customer account, while the FCM acts as a trade processor. Several models are currently being tested throughout the world, ranging from tri-party and quad-party models designed for swaps markets to direct customer accounts at exchanges.

While alternative segregation arrangements do provide end users with the comfort of having the FCM removed from direct access to their funds, these arrangements are merely 'bankruptcy-remote', in that they are still subject to a pro rata distribution of a shortfall if an FCM defaults. Making these arrangements 'bankruptcy-proof' may require changes to the Bankruptcy Code, but revisions to the CEA can help limit the extent to which a bankruptcy Trustee can pursue and distribute such Customer Property maintained in such arrangements.

The CEA should be amended so that alternative segregation arrangements are given their own separate account class status. This would limit the amount of Customer Property put at risk due in the event of an FCM insolvency in which there was a shortfall in Customer Property. While this would not clear these customers of fellow customer risk within their own account class, it would go a long way toward eliminating FCM malfeasance risk.

GIVE THE CFTC AUTHORITY TO DETERMINE THE APPROPRIATE LIQUIDATION PROCEEDING FOR INSOLVENT FCMs

Modern FCMs can have complicated corporate structures and many are dually registered as broker-dealers. As a result, there is confusion at the outset of an FCM default as to which statute will govern the broker liquidation. MF Global went through a SIPA Liquidation, despite the fact that its revenue was overwhelmingly derived from its FCM business line (38,000 commodity accounts compared to 200 securities accounts).

The CFTC is best positioned to determine the appropriate bankruptcy course for FCMs. The Committee should consider revising the CEA to give the CFTC authority to make that determination for any registered FCM.

EXAMINE WHETHER OR NOT THE CEA REQUIRES AN AMENDMENT TO PERMIT THE NFA TO RAISE ASSETS FOR AN INSURANCE FUND FROM ITS MEMBER ASSESSMENTS

As the Committee may be aware, the NFA is conducting a study regarding several types of customer account insurance. Although it may or may not be appropriate for the NFA to assume such a responsibility, the CCC believes that the NFA should be free to examine providing such a fund from fees and assessments it already raises from its membership. While we cannot find any provision of the CEA which would prevent NFA from using its member assessments to pay for a customer protection scheme or insurance fund, NFA President Daniel Roth testified before the Committee that a change in the statute is required:

> *With respect to a fee generated through NFA to cover the cost of the insurance, I would just point out as a technical matter that would require an amendment to the statue because under the existing law there are very strict limits on what we can use our fees and assessments for. They can only be used to defray reasonable administrative expenses.*[8]

Given Mr. Roth's testimony, we would like the Committee to consider what aspects of the CEA need to be revised to remove restrictions on the NFA's fees and assessments for the purposes of funding a customer protection fund or account insurance mechanism. The NFA should be free to determine

[8] Committee on Agriculture, Nutrition & Forestry. *Hearing: Examining the Futures Markets: Responding to the Failures of MF Global and Peregrine Financial Group.*

whether or not such a protection fund is consistent with its mission and resources, rather than have it precluded by limitations on its fee structure in the CEA or CFR.

GIVE THE CFTC AUTHORITY TO BRING CRIMINAL PROSECUTIONS

CFTC Commissioner Bart Chilton stated that as of February 2009, "DoJ initiated criminal action in only 65 of the 173 cases referred to it by the CFTC over the past five years.[9]" Considering that the majority of bad actors whom the CFTC, with its far greater level of commodity-related expertise, thinks should be in jail never face charges, there certainly is a great deal of slack to be taken up. Who would be better to do so than the CFTC, the agency with the pertinent expertise in a highly technical field?

Giving the CFTC the right/obligation to bring criminal charges would increase the budget required by the agency. This cost could be funded by repurposing the portion of the DoJ's budget assigned for commodity enforcement to the CFTC. Additionally, the CFTC could be allowed to keep all or a portion of the penalties it collects as a part of civil and criminal enforcements for use towards its operating needs. This would incentivize the agency to maximize the penalties it agrees to as part of settlement agreements and to be successful in prosecution of enforcement actions.

[9] "*CFTC's Chilton seeks criminal authority to fight market fraud*" http://www.agri-pulse.com/uploaded/20090227H.pdf

CMC

Commodity Markets Council
1300 L St., N.W. Suite 1020
Washington, DC 20005
Tel 202-842-0400
Fax 202-789-7223
www.commoditymkts.org

May 6, 2013

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

The Honorable Thad Cochran
Ranking Member
Senate Committee on Agriculture, Nutrition, and Forestry
328-A Russell Senate Office Building
Washington, DC 20510

Dear Chairwoman Stabenow and Ranking Member Cochran,

The Commodity Markets Council ("CMC") appreciates the opportunity to submit the following comments for consideration by the Senate Agriculture Committee ("Committee") in response to your letter dated March 7, 2013 requesting input on issues related to reauthorization that CMC would like the Committee to consider during the upcoming process to reauthorize the Commodity Futures Trading Commission ("CFTC").

CMC is a trade association that brings together exchanges and their industry counterparts. The activities of our members represent the complete spectrum of commercial end-users of all futures markets including energy and agriculture. Specifically, our industry member firms are regular users of the Chicago Board of Trade, Chicago Mercantile Exchange, ICE Futures US, Kansas City Board of Trade, Minneapolis Grain Exchange and the New York Mercantile Exchange. CMC is well positioned to provide the consensus views of commercial end-users of derivatives. Our comments represent the collective view of CMC's members.

The businesses of all our member firms depend upon the efficient and competitive functioning of the risk management products traded on U.S. futures exchanges. Through the Commission's diligent oversight efforts that have fostered exchange innovation and technology adoption, we have seen the commodity markets grow and prosper. They have become deeper and more liquid, narrowing bid/ask spreads and improving hedging effectiveness and price discovery. Meanwhile, liquidity, technology, clearing quality, price, and customer service have driven market selection. All of these developments serve the interests of the trade as well as the public. The regulation of swaps has also motivated a general industry move toward the futures market, which has been termed "futurization." While we will continue to transact swaps especially for more tailored transactions, we support the transition to futures. The regulated futures market fared well throughout the financial crisis and provides greater regulatory certainty for our members than the evolving swaps regulation. Given this, we strongly believe the Commission should avoid making unnecessary changes to futures regulation.

Generally our ideas for legislative changes fall into two main categories: improvements to the protection of customer collateral in derivatives markets and concerns related to the implementation of various provisions of the Dodd-Frank Act with respect to the impacts on commercial end-users. End-users will be the bearer of unnecessary costs imposed by the implementation of these provisions. Many of the final CFTC rules to implement Dodd-Frank are overreaching and provide no direct benefit to the US consumer or taxpayer. In sum, the added regulatory costs that the CFTC is forcing upon end-users and commercial participants will ultimately be passed on to the consumers of commodity products and will also reduce market liquidity, further raising the costs of risk management.

Protection of Customer Collateral

Given recent events surrounding the collapse of two Futures Commission Merchants ("FCMs") and the mismanagement and disappearance of customer collateral, we request that the Committee consider the various market driven proposals to further protect these assets, as they are vital to our member companies and all other market participants seeking to manage risk in the derivatives markets.

Customer Protection Proposal

CMC commends the efforts of the National Futures Association ("NFA") and the CFTC to improve certain aspects of how customer collateral is treated, although there is one particular issue raised by the CFTC that has caused opposition among our members. Specifically, CMC strongly believes that the proposed requirement that FCMs maintain a residual amount sufficient to cover on a constant basis the aggregate of customer margin deficits could create liquidity issues and increase costs for FCMs and end-users. Such a decrease in liquidity could be substantial and limit the number and type of transactions FCMs clear, the number of customers they service, and the amount of financing they provide. The proposal would require FCMs to fund accounts holding their customers' collateral with proprietary assets in excess of the aggregated margin deficiencies of all its clients on a continuous basis. The proposal also appears to require executing FCMs to collect collateral for give-ups so that customer positions are fully margined in the event a clearing FCM rejects a trade. If the proposed residual interest provision were to be finalized, FCMs may be forced to take steps such as over-margining clients, requiring clients to pre-fund their margin requirements, imposing punitive interest rate charges on margin deficit balances, and introducing intra-day margin calls. Such steps would dramatically increase the cost of using futures markets and may force many end-users to decrease or discontinue hedging and risk management practices, which is the reason these markets were created.

Market participants are active in developing methods of early detection of any improper transfer of customer funds due to errors or theft. For example the Chicago Mercantile Exchange ("CME") and the NFA have implemented various protective measures, including: 1) requirements regarding an FCM's residual financial interest in customer accounts, 2) restrictions on an FCM's disbursements from customer accounts, and 3) procedures that will facilitate monitoring of customer funds.

In order to detect an improper reporting of asset balances CME and NFA have implemented a number of measures, most of which relate to confirmation of balances and review of bank statements and certain FCM information. Both DSROs are using an aggregator to get bank balances reported to them electronically on a daily basis.

CME and NFA also perform limited reviews of the customer investments reported on the Segregated Investment Detail Reports to ensure compliance with the requirements of CFTC Rule 1.25. CME performs detailed audit work on risk-based examinations, including a review of qualified depositories, third-party statements, reconciliations, mark-to-market schedules, valuation (readily marketable and highly liquid), obtaining confirmations, etc. Additionally, in April 2012, CME started performing limited reviews of customer segregated, secured, and sequestered statements on a surprise basis outside of the regular risk-based examination.

End-User Concerns

The CFTC has been working diligently since the passage of Dodd-Frank in July of 2010 and should be commended for the progress they have made thus far. CMC recognized and supported the need for reform in the over-the-counter (OTC) swaps market and believes that Dodd-Frank provided a foundation for an effective overhaul of this important risk-management market. However, there are various issues that have arisen as part of the implementation process which we believe the Committee should revisit going forward, as they have the ability to drastically affect liquidity in these vital risk-management tools, driving up the costs of energy and agricultural products, and leaving companies more exposed to price volatility, of which decreased liquidity is a contributing factor.

Part 1.35 Recordkeeping Requirements

A significant and concerning expansion of current data requirements beyond the scope of Dodd-Frank is related to recordkeeping requirements in Part 1 of Commission regulations. In accordance with Dodd-Frank, the CFTC expanded the futures recordkeeping requirements that existed for certain markets participants to swaps. However, they also significantly expanded the written requirements, as well as created a new requirement to record oral conversations. Compliance costs have already been incredibly substantial now that compliance with the written requirements is mandatory and will only increase once compliance with the oral recording requirement becomes mandatory later this year. Again, the market is searching for a reason and measurable benefit for all of this new information that must be maintained and archived in a particular way. In addition, the rule is vague as to which communications must be retained, so in an abundance of caution, market participants are effectively saving every email, news article, or any other piece of information that might "lead to the execution of a transaction" and soon will have to begin recording every phone call that might "lead to the execution of a transaction." This vague "lead to..." language appears nowhere in any prior iteration of Rule 1.35 or in any prior CFTC Advisory relating to the rule, and operates to expand substantially the scope and burdens of the rule. Also, the application of the requirements to members of an exchange seems to have no regulatory rationale and only serves as a disincentive to be a member, something the Commission should encourage. Finally, there has been no sufficient cost benefit analysis to justify the cost figures by CFTC staff. Compliance costs are exponentially higher than they estimate, and in some cases the technology is not even available to market participants. Requests for clarification have not yet been answered, and CMC will be submitting a written request soon in a continued effort to clarify and hopefully narrow the scope of what must be retained and, therefore, reduce compliance cost.

Scope of Swap Dealer Definition

The Commission's final rule defining who must register as a swap dealer, a regulatory category that carries an immense regulatory burden and was designed for large financial institutions, is altering trading activity between commercial market participants and pushing more swap activity into the large dealer banks. This is directly counter to the goal of Dodd-Frank to <u>increase</u> competition and reduce the concentration of risk in a few large firms. We do not believe that Congress intended to capture commercial end-users as swap dealers for swap activity that is ancillary to their physical commodity business, but that is exactly what the final CFTC rule accomplishes. Chairman Gensler's own words to the Committee as he proposed the regulation of swap dealers were specific to large financial firms. At a Committee hearing on February 25, 2009, Gensler stated:

> *"I also think we need regulation of the institutions, that Congress would actually have a statutory regime for derivative dealers, somewhat like we have for banks, where you have capital rules which address the excess leverage, have business conduct rules to make sure there is not fraud and manipulation in the sales practices. And then, of course, lastly and very importantly, reporting rules. <u>These dealers--there is about 15 or 20 around the globe that make up 99 percent of the market for over-the-counter derivatives.</u>"*

Later in the same hearing:

> *"One was the concept of regulating the dealers themselves, the brokers, the voice brokers or derivative dealers that are making markets. We all know their names. <u>I will not name them here, but the large financial institutions.</u>"*

In their final rule, the CFTC estimates that 125 entities will be required to register as swap dealers, far exceeding the 15-20 entities the Chairman suggested be regulated. Many commercial market participants are curtailing trading activities with other end-users for fear of being captured by a complicated, capital-based regulatory regime designed for large financial institutions that most end-users are incapable of complying with. We do not believe this was the intent of Congress, and in fact seems to be the complete opposite outcome by further consolidating trading activity in a few large financial institutions. We urge the Committee to revisit this very important issue.

Reporting and Recordkeeping under Part 46

Part 46 of the Commission's regulations requires market participants to report swap trades entered into from July 21, 2010, when the Congress passed Dodd-Frank, until April 10, 2013. Included in the transactions subject to this requirement are energy swaps as well as cleared Exchange of Futures for Related Positions ("EFRP") trades, which were centrally cleared by the CME Group and Intercontinental Exchange. In these transactions, the original trade only occurs if it is accepted for clearing, and once it is, the original trade is terminated and replaced with two new trades with each of the original executing counterparties facing the clearinghouse. The original trade creates zero risk, and the reporting of the trade serves no regulatory purpose that we can discern. The reporting requirement does, however, create a significant compliance burden on end-users. Given that the data is available to regulators from the clearinghouses and the clearinghouses have reported the trades on the market's behalf, the CFTC should grant the multiple requests from market participants to waive the historical reporting requirement for end-users.

Real-Time Reporting

Under the real-time reporting rule, end-users have a longer time in which to report trades with other end-users. However, trades that involve a swap dealer or major swap participant must be reported in a much shorter time after execution. Because the rule requires trades between a non-dealer and a swap dealer be reported within the dealer's time limit, swap dealers and major swap participants have limited time to lay off risk before the trade is made public. While the delay may be sufficient for liquid markets, they are not sufficient for illiquid markets and time frames. When a dealer has to report such illiquid trades to the market quickly and the dealer may not be able to lay off the risk of that trade in the prescribed time, the dealer is taking a risk and will charge the counterparty (here, the commercial end-user) for that increased risk if they are willing to execute the trade at all. This increased cost and possible inability to trade in illiquid markets will hurt commercial end-users.

Inter-Affiliate Transactions

Inter-affiliate trades are subject to recordkeeping requirements under Part 45, requiring that the records of inter-affiliate swaps are "full, complete, and systematic." We view this requirement as burdensome and providing very little benefit relative to the increased cost to our members. The information that the Commission is seeking is available through the visibility of market-facing swaps, as they are largely identical. Additionally, these inter-affiliate and market-facing trades are for purposes of hedging or mitigating commercial risk and are documented pursuant to inter-affiliate agreement such that both parties must make payments and deliveries specified, although the transactions may be settled by an intercompany transfer or allocation. The internal documentation is done as necessary for internal purposes, but may not contain all information required or in the format required under Part 45.

With respect to mandatory clearing and the end-user exception, we appreciate the Commission's recent relief providing an exemption for swaps between commonly owned affiliates. The Commission still needs to clarify that swaps entered into by a centralized hedge function of a commercial entity are eligible for the end-user clearing exception when hedging on behalf of the commercial company, whether or not the entity housing the hedge function for the company is by definition a financial entity.

Position Limits Aggregation and Reporting of Daily Physical Positions

The CFTC's rule imposing position limits for swaps and futures was vacated in September 2012 [shortly before compliance became mandatory]. The part of the rule that addressed aggregation of entities for purposes of position limits was re-proposed, but not finalized before the rule was vacated. That re-proposal required aggregation of entities in which one has ownership of the other of 50% or greater, and provided an exception from aggregation at 10% or lower ownership level. Between 10%-50%, there is a multi-factor test to determine if aggregation of required, with a presumption of control. Although the rule has been vacated, the CFTC has both appealed the court's ruling and drafting a new proposal. We urge the CFTC to adopt a rule that requires aggregation based on control, rather than percent ownership and not to include any presumption of control. Aggregation is appropriate only when one entity controls the trading activity of another entity or has unfettered access to trading information of such other entity that could be used to facilitate its own trading. Absent such control and access to information, aggregation should not be required, regardless of the percent ownership or equity interest in the owned entity. For example, in the context of a limited partnership, a limited partner may own a majority of the partnership and be entitled to the majority of its profits, although day-to-day control of the partnership actually vests with the general partner. Further, it is particularly true in connection with joint ventures that majority ownership does not necessarily equate to the majority owner's control of the owned entity's trading activity.

The automatic application of the aggregation requirement to persons holding in excess of 50% ownership or equity interest would force market participants to share information and coordinate trading, which is exactly what the CFTC seeks to prevent. Such sharing of information may also raise antitrust concerns, notwithstanding the Commission's clarification that an information sharing exemption will be granted provided such initial sharing of information does not give rise to a "reasonable risk" of violating federal laws. Under the final position limits rule, affiliated entities will be required to assign position limits among several accounts that are presently traded independently of, and in competition with, each other. CMC is concerned that continuous correspondence and negotiations between affiliated entities will expose them to charges of collusive and anticompetitive behavior. Given the nature of trading, it is highly impractical to ask the opinion of counsel as to whether information sharing at any point during intra-day trading gives rise to a "reasonable risk" of federal antitrust laws being violated. As such, in practice, affiliated entities will be unable to avail themselves of the protection seemingly afforded by the information sharing exemption currently constructed in Part 151.7(i).

The vacated position limits rule also required the reporting of daily physical positions to justify hedge exemptions, which under the rule were only available to commercial market participants, rather than the historical requirement of monthly physical position reporting. The change would be virtually impossible for a global commodities firm to comply with. The industry viewed the change as unnecessary and overly burdensome, given that the Commission has always had the ability to ask for data to justify a hedge exemption. We do not believe it is an efficient or productive use of resources to devote the time that would be required to review all of the new data and, if those resources are not devoted to review all of the data, it is inefficient to collect given that the CFTC may at any time ask for the data. We believe the CFTC should retain the historical requirement to report monthly positions in the new position limits proposal.

Bona Fide Hedging

Congress provided a definition of a bona fide hedge within Dodd-Frank that the CFTC has unnecessarily narrowed, including related to anticipatory hedging, and has created at least five different definitions in various rules of what constitutes a bona fide hedge. This is nonsensical and creates unnecessary confusion, while disruptive to legitimate risk mitigation practices. We are committed to working with Congress to set clearer direction on bonafide hedges so that transactions that limit economic risks are viewed as bona fide hedges by the CFTC.

Conclusion

In conclusion, the swap reforms in Dodd-Frank were not necessary because of problems in physical commodity markets. Commercial end-users had no role in creating the financial crisis. Contrary to the insufficient cost-benefit analysis accompanying many, the continued barrage of overly burdensome CFTC rulemakings is causing compliance costs to skyrocket. In addition, significant regulatory uncertainty continues to exist, and despite the approximately 100 various letters issued by the Commission to clarify rule language or extend compliance dates, many questions still remain and many end-users are unprepared to comply with the overly prescriptive regulation that has been issued by the CFTC to date. CMC looks forward to working with the Committee as this important process continues and appreciates the invitation to submit comments.

Sincerely,

CMPC

Charles P. Carey
Chairman
Commodity Markets Council

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.

Coalition Contact: Jim Collura
jim.collura@nefi.com

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)

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.

---

[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

Coalition Contact: Jim Collura
jim.collura@nefi.com

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.

Coalition Contact: Jim Collura
jim.collura@nefi.com

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.**

---

[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.

Coalition Contact: Jim Collura
jim.collura@nefi.com

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)

Coalition Contact: Jim Collura
jim.collura@nefi.com

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

CFA **Consumer Federation of America**

May 1, 2013

The Honorable Debbie Stabenow
Chairman
Committee on Agriculture, Nutrition
and Forestry
U.S. Senate
Washington, D.C. 20510

The Honorable Thad Cochran
Ranking Member
Committee on Agriculture, Nutrition
and Forestry
U.S. Senate
Washington, D.C. 20510

Dear Chairman Stabenow and Ranking Member Cochran:

Thank you for the invitation to submit suggestions regarding issues to be addressed in the upcoming reauthorization of the Commodity Futures Trading Commission. We congratulate you for establishing an open and bipartisan process and for seeking input from a broad range of interested parties. We hope that the end result of that process will be a bipartisan bill that puts the agency on a sound financial footing, strengthens its authority in key areas, and shores up the crucially important derivatives market reforms adopted in the Wall Street Reform and Consumer Protection Act.

CFA is an active participant in both Americans for Financial Reform and the Commodity Markets Oversight Coalition, both of which are writing separately to suggest a broader range of issues to be addressed. For the purpose of this letter, however, we will highlight two issues where CFA has taken a more active role: CFTC self-funding and cross-border application of derivatives regulations. Both increased funding for the agency and a strong cross-border policy are crucial to delivering the financial market reforms promised by Congress when it passed the Wall Street Reform legislation

I. Put the CFTC on the Same Self-Funding Footing as Federal Banking Regulators

As your letter correctly notes, this year's reauthorization comes at an important but challenging time. Unlike other better funded federal financial regulators, the CFTC is nearing completion of the rule-writing phase of Wall Street reform and has begun actual implementation of rules designed to reduce risk, promote market integrity, and bring transparency to the over-the-counter swaps market. This is a remarkable achievement for a tiny agency operating on a shoe-string budget and facing resistance from well-funded and powerful Wall Street firms intent on maintaining the excessive profits they have long been able to extract from an opaque and unregulated market.

As the agency transitions from a primary focus on rule-writing to implementation, its ability to fulfill its regulatory mandate is seriously imperiled by a funding level that doesn't begin to match the scope of its responsibilities. Starving the agency of resources during this crucial implementation phase puts us all at risk: at risk that irresponsible Wall Street practices will go unchecked, threatening the stability of the global economy; at risk that unrestrained speculation in commodity markets will impede the ability of farmers and Main Street businesses to hedge their risks; at risk that municipalities, endowments, pension funds and other less sophisticated participants in the swaps markets will once again become victims of predatory practices. The ultimate victims will be the average Americans who pay for this abusive conduct in higher prices at the grocery store and the gas pump and who will be forced to bear the burden if a financial system run amok once again requires a rescue.

Many members of this Committee recognize the importance of the CFTC and have led the fight for increased funding to match the agency's increased workload. We greatly appreciate those efforts. As you know all too well, the agency had seen its funding severely eroded in the years leading up to the financial crisis. Its budget in 2007 provided a staffing level 23 percent below what it had been in 1999, a period during which the size of the markets it was responsible for overseeing grew five-fold. While some progress was made in the immediate aftermath of the crisis to restore prior staffing levels, the agency has never received the increased funding levels promised in the Wall Street reform legislation. The sad fact is that while the Senate has consistently supported funding increases, some in the House who opposed Wall Street reform have attempted to weaken and stall its implementation by denying adequate funding to the CFTC. The sequestration, with its indiscriminate funding cuts, only makes the problem worse.

The resulting underfunding will inevitably undermine implementation of the Wall Street reform law. It will make the CFTC slower to process registration applications and industry requests for guidance. It will undercut the agency's ability to spot and respond quickly to emerging threats. And it will weaken enforcement efforts just as recent examples – the "London whale," Libor manipulation, and the MF Global bankruptcy to name just a few – have shown how rife with abuse these markets have become and how crucial a strong enforcement program and effective regulatory oversight are to market integrity and investor confidence.

For all these reasons, we believe the only answer is to finally put the CFTC on the same sound financial footing that virtually all other federal financial regulators enjoy through their ability to collect fees and set their budgets outside the congressional appropriations process. Two arguments are typically made against this proposal. Neither is convincing, in our view, particularly when weighed against the persistent under-funding which this agency has suffered.

- Wall Street typically argues that authorizing the CFTC to impose user fees would drive up costs that would be passed on to consumers and businesses. But major Wall Street firms have been known to charge fees that greatly exceed the agency's entire annual budget to a single customer to unwind a single deal, as J.P. Morgan proposed to do in the deal that drove Jefferson County into bankruptcy. In fact, given the size of the markets the CFTC oversees – a roughly \$30 trillion commodity market and \$300 trillion swaps market – any such user fees would be so tiny as to be all but undetectable.

- Congressional appropriators have sometimes argued that self-funding would seriously diminish Congress's ability to provide necessary oversight of the agency. Those who make this argument do not explain why a system that seems to function perfectly adequately for oversight of self-funded federal banking regulators or the newly created Consumer Financial Protection Bureau could not work similarly well for the CFTC. Moreover, as you well know, the House and Senate agriculture committees would retain both unimpeded ability to conduct congressional oversight and the tools necessary to ensure that the agency is using its resources wisely and effectively. The reauthorization process is one such tool.

Given a history of chronic underfunding, and in light of the crucial role the CFTC plays in safeguarding our nation's financial security, we believe the benefits of self-funding greatly outweigh any such questionable concerns. We urge you to include self-funding legislation in the reauthorization bill.

II. Ensure Strong Cross-border Application of Derivatives Regulations

Efforts led by this Committee to reduce the risks, increase the transparency, rein in excessive speculation, and promote effective oversight of over-the-counter swaps markets will be for naught if swaps dealers can evade regulations simply by conducting their transactions overseas. Today's financial markets are global in scope. It is an inescapable fact that modern technology enables large, multi-national swaps dealers to shift the "location" of transactions among hundreds, even thousands, of international affiliates in a matter of seconds. While the transactions (and financial services jobs) may migrate to foreign jurisdictions absent a strong cross-border policy, the risks will still come home to haunt us, as the U.S.-based parent company will still be on the hook for any resulting losses. Congress recognized that threat when it included a requirement in the Wall Street reform bill that these regulations must apply not just within our borders, but also to any activities outside the United States that have "a direct and significant connection with activities in, or effect on, commerce" of the United States.

In attempting to adopt an approach to cross-border application of U.S. rules that is consistent with this congressional mandate, CFTC Chairman Gary Gensler has met with stiff resistance not just from Wall Street but also from some foreign regulators, who argue that the United States should simply rely on them to regulate within their borders. But this would be a recipe for disaster. Despite their protestations, most foreign regulators are well behind the United States in finalizing those regulations. To delay implementation of our cross-border policy in order to defer to them would be to delay protections for U.S. investors and businesses that rely on these markets, perhaps for years or until the next financial crisis creates a new urgency for action. Moreover, it is not yet clear whether even the leading market regulators (in Europe and the United Kingdom, for example) will impose safeguards as rigorous as those required under U.S. law. Indeed, it is inevitable that some markets will seek to carve out a niche by offering businesses a haven from rigorous regulation, irresponsibly threatening the integrity and stability of global financial markets.

The good news here is that the statute already applies an appropriately comprehensive standard for cross-border application of U.S. rules. Our request to the Committee in this instance is first to ensure that this legislation does nothing to narrow the scope of the existing cross-border statutory language and second to ensure that the policy adopted by the CFTC to implement this provision is fully consistent with the statutory mandate. To achieve that goal, it is absolutely essential that:

- U.S. laws must apply to *all* foreign subsidiaries of U.S. companies. By the same token, U.S. laws must apply to all foreign companies that do more than a *de minimis* amount of business with U.S. entities, including overseas affiliates guaranteed by U.S companies.

- Substituted compliance must only be granted in those jurisdictions that have genuinely comparable rules, both in terms of the substance of the rules and the vigor of their enforcement. General comparability, along the lines proposed earlier today by the SEC, is simply not adequate.

- The decision to grant substituted compliance must be based on clear and detailed standards through a transparent process in which the rationale for granting substituted compliance is documented. Blanket exemptions must not be granted to jurisdictions that meet some, but not all, of the standards necessary for true comparability.

- Any decision about whether to rely on a foreign regulator under a substituted compliance approach must be deferred until that regulator has adopted and begun to implement its regulatory regime. The United States cannot delay application of its laws while other countries catch up, and it cannot defer to regulations that are not yet being enforced.

CFTC Chairman Gary Gensler has shown that he understands the importance of this issue, and he has fought vigorously to win adoption of a strong cross-border policy at the CFTC. We urge this Committee to use the reauthorization process to reaffirm its support for a strong and comprehensive approach to cross-border application of derivatives rules and to spur the CFTC to speed implementation of a policy that is consistent with the broad scope of the statutory language.

* * *

The CFTC has much to be proud of in its implementation of the Wall Street reform legislation. It has set a standard for relatively timely completion of rulemakings that better funded federal financial regulators cannot approach, let alone match. The reauthorization process offers an opportunity to fine-tune the agencies' operations, providing resources, authority and direction to ensure that it can fulfill its immense and immensely important regulatory responsibilities effectively and efficiently. We look forward to working with the Committee on what we hope will be strong, bipartisan legislation that advances our shared goal of promoting the transparency, integrity, and stability of our nation's futures and swaps markets.

Respectfully submitted,

Barbara Roper
Director of Investor Protection

cc: Members of the Committee

Council of Institutional Investors

Via Hand Delivery

May 1, 2013

The Honorable Debbie Stabenow	The Honorable Thad Cochran
Chairman	Ranking Member
Committee on Agriculture, Nutrition and Forestry	Committee on Agriculture, Nutrition and Forestry
United States Senate	United States Senate
Washington, DC 20510	Washington, DC 20510

Dear Madam Chairwoman and Ranking Member Cochran:

I am writing on behalf of the Council of Institutional Investors ("CII"), a nonpartisan, nonprofit association of pension funds, other employee benefit funds, endowments and foundations with combined assets that exceed $3 trillion. Council members are large, long-term investors responsible for protecting the retirement savings of millions of American workers and retirees.[1]

The purpose of this letter is to respond to your March 5, 2013, request for input on the Commodity Futures Trading Commission ("CFTC") and "related issues including market oversight, agency oversight and resources, and statutory authorities."[2] As long-term investors, we respectfully request that the Committee carefully consider the following two issues relating to the CFTC:

1. Implementation and enforcement of the central clearing and trading requirements of the Wall Street Reform and Consumer Protection Act ("Dodd-Frank")

In our view, the most important provisions of Title VII of Dodd-Frank are those that provide that over-the-counter ("OTC") derivatives should generally be centrally cleared and exchange traded. Central clearing substantially reduces counterparty risk, and exchange trading provides valuable pre-and post-trade transparency to investors, regulators, and other market participants.[3]

---

[1] For more information about the Council of Institutional Investors ("CII") and its members, please visit our Web site at http://www.cii.org/about_us.

[2] Letter from Chairman Stabenow & Ranking Member Cochran to Stakeholders (Mar. 5, 2013) (on file with CII), *available at* http://www.ag.senate.gov/newsroom/press/release/stabenow-cochran-cftc-reauthorization-letter.

[3] *See, e.g.*, Investors' Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective 11 (July 2009) (on file with CII), *available at* http://www.cii.org/files/issues_and_advocacy/dodd-frank_act/07_01_09_iwg_report.pdf (Recommending that "Congress and the Administration should enact legislation overturning the exemptive provisions of the CFMA and requiring standardized and (standardizable)

Moreover, an important by-product of increased transparency for OTC derivatives is the reduction of transaction costs for institutional investors.[4] We, therefore, urge the Committee to use its oversight of the CFTC to ensure that there is rigorous implementation and enforcement of the clearing and trading requirements of Dodd-Frank.

2. Sufficient, stable and long-term funding

Rigorous implementation and enforcement of the clearing and trading provisions of Dodd-Frank requires that the CFTC has sufficient, stable and long-term funding.[5] As you are aware, funding for the CFTC has simply not kept pace with the growth in the markets it is responsible for overseeing.

Over approximately the past twenty years the futures markets have grown fivefold while the staff of the CFTC has grown by only seven percent.[6] Even more alarming, as a result of Dodd-Frank the CFTC now directly oversees the swaps markets *which are eight times larger than the futures markets*.[7]

In order to properly safeguard investors and the financial markets, we believe the CFTC should have a funding mechanism that would ensure that it has the necessary resources to hire a staff of sufficient size and skill, and obtain and maintain the technology needed, to effectively oversee the nation's swaps and futures markets and respond to technological changes as they are adopted in the marketplace.[8] The funding mechanism should also allow the CFTC to engage in more predictable long-term planning.

Regardless of the CFTC's funding mechanism, Council members and many other market participants rely, in significant part, on a strong and active CFTC to develop and enforce the market rules necessary to promote transparency and lower the risk of the derivatives markets. We, therefore, urge the Committee to evaluate the

---

derivatives contracts to be traded on regulated derivatives exchanges and cleared through regulated derivatives clearing operations.").

[4] *Id.*

[5] *See id.* at 9 (Recommending that "[r]egulators should have enhanced independence through stable, long-term funding that meets their needs.").

[6] Hearing Before the H. Subcomm. on Agric., Rural Dev., Food & Drug Admin., and Related Agencies, 113th Cong. 9 (Apr. 12, 2013) (Testimony of Gary Gensler, Chairman, Commodity Futures Trading Commission) (on file with CII), *available at* http://appropriations.house.gov/uploadedfiles/hhrg-113-ap01-wstate-genslerg-20130412.pdf.

[7] *Id.*

[8] See, e.g., Investors' Working Group at 8.

resources the CFTC needs to fulfill its mission and actively support sufficient, stable, and long-term funding that provides the CFTC the tools that are critical to performing its important role for investors and the financial markets.

We appreciate the opportunity to share with you our views. Please feel free to contact me at (202) 261-7081 or jeff@cii.org if you should have any questions regarding CII or the contents of this letter.

Sincerely,

Jeff Mahoney

Jeff Mahoney
General Counsel

FIA

Futures Industry Association
2001 Pennsylvania Ave. NW
Suite 600
Washington, DC 20006-1823

202.466.5460
202.296.3184 fax
www.futuresindustry.org

May 1, 2013

The Honorable Debbie Stabenow
Chairwoman
United States Senate
Committee on Agriculture, Nutrition and Forestry
328A Russell Senate Office Building
Washington, D.C. 20510

The Honorable Thad Cochran
Ranking Republican Member
United States Senate
Committee on Agriculture, Nutrition and Forestry
328A Russell Senate Office Building
Washington, D.C. 20510

Dear Chairwoman Stabenow and Ranking Member Cochran:

The Futures Industry (FIA) is pleased to submit this letter in response to your request for recommendations regarding potential amendments to the Commodity Exchange Act (Act) in connection with the reauthorization of the Commodity Futures Trading Commission (Commission). We commend you both for continuing the Committee's strong tradition of approaching issues in a bi-partisan manner and look forward to participating in an ongoing dialogue with you during the course of this process.

FIA is the leading trade organization for the futures, options and over-the-counter cleared derivatives markets. It is the only association representative of all organizations that have an interest in the listed derivatives markets. Its membership includes the world's largest derivatives clearing firms, as well as leading derivatives exchanges from more than 20 countries. FIA's core constituency consists of futures commission merchants, and the primary focus of the association is the global use of exchanges, trading systems and clearinghouses for derivatives transactions. Our members provide the majority of the funds that support derivatives clearinghouses and commit a substantial amount of their own capital to guarantee customer transactions.

FIA is uniquely situated to provide insight into the operation of the global derivatives markets, and the periodic Congressional reauthorization of the Commission presents a welcomed opportunity to review the current application of the Act to these markets.

Customer Protection

The failures of MF Global Inc. and Peregrine Financial Group resulted in severe and unacceptable consequences for thousands of futures customers and the markets generally, and we agree that a review of current protections afforded to customers under the Act is warranted. The entire industry has been working collaboratively to identify and improve procedures required to better protect the integrity of these markets. A number of changes are already being implemented, many of which were recommended by FIA in the aftermath of these insolvencies[1]:

- The National Futures Association (NFA) and CME Group, the industry's principal designated self-regulatory organizations (DSROs), have adopted rules that subject all futures commission merchants (FCMs), to enhanced recordkeeping and reporting obligations, including: (i) transmitting daily customer segregation balances to their respective DSRO; and (ii) requiring the chief financial officer or other appropriate senior officer to authorize in writing and promptly notify the FCM's DSRO whenever an FCM seeks to withdraw more than 25 percent of its excess funds (*i.e.*, the FCM's "residual interest") from the customer segregated account in any day.

- NFA and CME Group have begun building an automated system for the daily monitoring of all customer segregated, secured, and cleared swaps amounts held by FCMs. As part of this project, NFA and CME contracted with AlphaMetrix360, a subsidiary of AlphaMetrix Group, to aggregate the data on customer segregated, secured, and cleared swaps amount accounts. The new system will allow NFA and CME to run an automated comparison of the balances in customer segregated, secured, and cleared swaps accounts at the depositories with the daily reports they receive from FCMs, and then quickly identify any discrepancies.

- NFA is also collecting additional financial information from FCMs and posting that information on its online Background Affiliation Status Information Center (Basic) system, a key step in giving customers the tools they need to monitor the assets they deposit with their FCMs. The new service provides the public with access to specific information about an FCM, such as the firm's adjusted net capital, the amount of funds held in segregated, secured, and cleared swaps accounts, and the types of investments that the FCM is making with those customer funds.

- FIA has issued Frequently Asked Questions on Customer Funds Protection[2], which are being used by FCMs to provide their customers with increased disclosure on the scope of how the laws and regulations protect customers in the futures markets.

---

[1] See Futures Industry Association, Futures Markets Financial Integrity Task Force - Initial Recommendations for Customer Funds Protection:
http://www.futuresindustry.org/downloads/Initial_Recommendations_for_Customer_Funds_Protection.pdf

[2] See Protection of Customer Funds, Frequently Asked Questions: http://www.futuresindustry.org/downloads/PCF-FAQs.PDF

- Additionally, FIA, CME Group, NFA, and the Institute for Financial Markets have partnered to fund an evaluation of the costs and benefits of various asset protection insurance proposals. We look forward to sharing these findings with the Committee when available.

The FIA is very engaged in the development of industry and Commission-initiated efforts to proactively address many of the issues presented by these recent failures. We are also mindful that the effects of these recent enhancements may not yet be fully realized and expect Congress will want to see the ultimate results before making major changes to the statute. Even so the reauthorization process may present an opportunity for the following targeted improvements:

Foreign Futures and Foreign Options Secured Amount
Although the Act authorizes the Commission to adopt rules relating to the protection of customer funds deposited to margin transactions effected on foreign boards of trade, the Act does not specifically prescribe that the calculation methodology for secured amounts on such foreign markets be comparable to that required on US futures markets. As a result, the calculation method applicable to the secured amount requirement for foreign futures and options is different from the calculation method for transactions based on US futures markets.
While Congress and the CFTC have long and rightfully recognized customer funds deposited with an FCM to margin foreign futures and options transactions are inevitably subject to different risks because they are held outside of the US, and are subject to the bankruptcy and regulatory regime of the jurisdiction in which the market is located, we believe that customer asset protection for foreign futures and options could be increased by elimination of the differences in the calculation methodology of the secured amount.

Modifications to the Bankruptcy Code
Although outside of the Act, the Bankruptcy Code may also require amendment to account for apparent shortcomings identified in the aftermath of recent bankruptcies. FIA continues to coordinate with DSROs, derivatives clearing organizations (DCOs) and various customers to identify such potential modifications.

Bona Fide Hedging
In 2010, Congress amended the Act to statutorily instruct the Commission in how to define what constitutes a bona fide hedging transaction or position. The statutory definition correctly stipulates that the reduction of risk inherent to a commercial enterprise is essential in determining what qualifies as a bona fide hedging transaction. However, some of the risk reducing practices commonly used in the futures markets today have been excluded from a list of enumerated bona fide hedging transactions prescribed in Rule 151.5(a)(2). For example, please find attached for your consideration a complete petition prepared by the Working Group of Commercial Energy Firms which details the types of transactions that require further consideration as bona fide hedging tools[3].

[3] Petition for Commission Order Granting Exemptive Relief for Certain Bona Fide Hedging Transactions Under Section 4a(a)(7) of the Commodity Exchange Act:
http://www.futuresindustry.org/downloads/WorkingGroup-BonaFideHedgingPetition.pdf

Process Improvements

Because the FIA appreciates the tremendous responsibility that the "Dodd-Frank Act" has bestowed upon the Commission, below are several suggested process improvements that seek to encourage more well-guided and efficient implementation of new regulations.

- As opposed to an obligation to "consider" costs and benefits, the Commission should be required to fully assess and quantify the costs and benefits associated with the rules and orders it puts forward.

- The application of new Commission-imposed regulations across international jurisdictions should be considered through a formal rule-making process to properly account for various stakeholders' input and to further predictability and consistency among various jurisdictions.

- To date, the Commission has not exercised its statutory authority to exempt from registration comparably regulated foreign clearing organizations, which are clearing swaps. We are concerned that failure to stipulate the process for such an exemption may result in foreign regulatory authorities retaliating and making it more difficult for US FCMs and clearing organizations to conduct business globally. Congress, therefore, may want to consider requiring the Commission to provide guidance as to how this exemption, specifically allowed by the statute, may be achieved.

As you noted in your March 7 letter, the reauthorization comes at a particularly important and challenging time. The Committee will simultaneously review the Commission's on-going implementation of newly granted responsibilities under the "Dodd-Frank Act" while also examining authorities of the Commission and the DSROs which are designed to ensure the protection of customer funds. This is no small task and, again, we commend you for your efforts. FIA is committed to working with you to achieve a positive outcome that both protects the integrity of these markets and maintains appropriate flexibility to adequately regulate their rapid evolution.

Sincerely,

Walt L. Lukken

Walt Lukken
President & Chief Executive Officer

INSTITUTE FOR AGRICULTURE AND TRADE POLICY

Senator Deborah Stabenow
Chairwoman

May 1, 2013

Senator Thad Cochran
Ranking Member
U.S. Senate Committee on Agriculture

Comment on the 2013 Reauthorization of the Commodity Futures Trading Commission (cftcreauthorization@ag.senate.gov)

Dear Senators Stabenow and Cochran,

The Institute for Agriculture and Trade Policy (IATP) is a nonprofit, 501(c)(3) nongovernmental organization, headquartered in Minneapolis, Minn., with an office in Washington, D.C. Our mission states, "The Institute for Agriculture and Trade Policy works locally and globally at the intersection of policy and practice to ensure fair and sustainable food, farm and trade systems." To carry out this mission, as regards commodity and derivatives market regulation, IATP has participated in the Commodity Markets Oversight Coalition (CMOC) since 2009, and in the Derivatives Task Force of the Americans for Financial Reform (AFR) since 2010. Jointly with CMOC and AFR and as an individual organization, IATP has submitted several comments on CFTC rulemaking, and on consultation papers of the International Organization of Securities Commissions, the European Securities and Markets Authority, and the European Commission's Directorate General for Internal Markets.

Thank you for this opportunity to comment on the reauthorization of the Commodity Futures Trading Commission (CFTC). First, we will make a general argument for reauthorizing the CFTC to undertake new rule-making, guidance and studies beyond what was authorized in the "Dodd Frank Wall Street Reform and Consumer Protection Act of 2010" (DFA) and the 2008 Farm Bill reauthorization. Then we will outline specific issue areas for which the Senate Committee on Agriculture should propose terms for CFTC reauthorization.

General comment

In the 113th Congress, already a dozen bills have been introduced to thwart the CFTC's discretion to implement Title VII of the DFA, and indeed, to annul the legislative intent of the DFA itself.[1] IATP has criticized these counter-reform initiatives by contributing to and supporting AFR's detailed opposition letters.[2] Even prior to the budget sequester, the House of Representatives had proposed a CFTC budget adequate to the CFTC of the late 1990s, when the agency oversaw a market one fifth of the current gross notional value in U.S. futures contracts and one fortieth of the gross notional value of over-the-counter (OTC) swaps contracts. Recognizing that the House-proposed budget was inadequate to enforcing the Commodity Exchange Act (CEA), much less to implement the DFA, IATP also has supported CMOC and AFR letters to base the CFTC budget on financial service industry and derivatives end-user service fees.[3] The marked increase in CFTC investigations and enforcement actions into violations of the CEA and other U.S. laws, including global entity violations damaging

1. David Dayen, "Is JP Morgan a Farmer?" Salon, March 20, 2013. http://www.salon.com/2013/03/20/j_p_morgan_is_not_a_farmer/ and Silla Brush, "Wall Street Wins Under Swap- Rule Changes Moving in House," Reuters, March 20, 2013. http://www.bloomberg.com/news/2013-03-19/wall-street-may-win-swap-rule-reprieve-in-u-s-house-legislation.html
2. http://ourfinancialsecurity.org/category/letters-to-congress/
3. e.g., http://www.nefiactioncenter.com/PDF/cmoc_cftcfunding_senate_2011_final.pdf

2105 FIRST AVENUE SOUTH MINNEAPOLIS, MINNESOTA 55404 (612) 870-0453 FAX (612) 870-4846 IATP.ORG
1100 FIFTEENTH STREET NW 11TH FLOOR WASHINGTON, D.C. 20005 (202) 222-0749

the U.S. economy, such as the Libor price fixing and the "ISDA [International Swaps and Derivatives Association] fix,"[4] require an adequately resourced agency, as well as one with clear and strong legislative authority. Otherwise, interest rate manipulation and OTC interest rate contracts based on those manipulated rates will continue to inflict billions of dollars of illicit costs on the private sector and on public budgets, e.g., municipal and state bond auctions.[5]

It would be a huge mistake to reauthorize the CFTC in terms that would weaken its ability to implement the DFA and enforce the CEA. From 2007 to 2010, the Federal Reserve Bank system rescued both U.S. and European OTC broker dealers with more than $19 trillion in ultra-low interest rate emergency loans, and enabled European and other central banks to rescue their banks with another $10 trillion in emergency loans.[6] Nevertheless, according to a recent Bank for International Settlements report, there is "...no evidence that that rescued banks reduced the riskiness of their new lending more than non-rescued banks in response to the crisis and the public rescues."[7]

To reward unreformed and defiant U.S. and foreign private financial institutions seeking yet more exemptions, exclusions and waivers with a CFTC reauthorization that does not strengthen the "comparable comprehensive oversight" required by the DFA, would be to invite more financial civil and criminal violations, regulatory evasion and speculative bubbles. As you consider the terms for CFTC reauthorization, we recommend that you read Senator Carl Levin's April 23 letter to the CFTC.[8] The letter is a powerful reminder that the terms of the CFTC reauthorization have consequences not only for U.S. commercial hedgers and financial firms, but for also for the foreign affiliates of U.S. banks whose unregulated trading practices have had devastating consequences for the U.S. economy.

Finally, given the possibility that a Farm Bill will not be passed in 2013[9], we urge you and your fellow Senators to vote on a stand-alone CFTC reauthorization, rather than wait to incorporate it into a 2014 or 2015 Farm Bill.

Specific issues for CFTC reauthorization

Studies on the effect of financial institution trading of physical commodities on commodity derivatives prices and risk management capacity of commercial hedgers

The CFTC does not have authority over the trading of physical commodities. However, the warehousing and trading of physical commodities affects both the price and physically deliverable supply of the underlying assets of the derivatives contracts under CFTC authority. Regulations and waivers promulgated by the Federal Reserve Board of Governors under the authority of the International Bank Act, the Bank Holding Company Act[10], and the "grandfathering clause" of the Graham Leach Bliley Act[11] allow U.S. financial holding companies (FHCs) and the U.S. affiliates of foreign financial companies to trade physical commodities in U.S. markets as "complementary powers" to their core business activities. The three largest U.S. FHCs are JP Morgan, Morgan Stanley and Goldman Sachs.

4. http://www.businessweek.com/articles/2013-04-18/meet-isdafix-the-libor-scandals-sequel#rshare=email_article and Carrie Mollenkamp, Jennifer Ablan and Jeffrey Goldstein, "How Gaming the LIBOR Became Business As Usual," Reuters, November 20, 2012. http://www.reuters.com/article/2012/11/20/us-libor-fixing-origins-idUSBR
5. Matti Taibbi, "Everything is Rigged: The Biggest Price Fixing Scandal Ever," Rolling Stone, May 9, 2013. http://www.rollingstone.com/politics/news/everything-is-rigged-the-biggest-financial-scandal-yet-20130425
6. James Andrew Felkerson, ""$29,000,000,000,000: A Detailed Look at the Fed's Bailout by Funding Facility and Recipient," Levy Economics Institute, Working Paper 698, December 2011. http://www.levyinstitute.org/publications/?docid=1462
7. Michael Brei and Blaise Gadanecz, "Have Public Bailouts Made Banks' Loan Books Safer?" Banks for International Settlements Quarterly Review, September 2012, 62. http://www.bis.org/publ/qtrpdf/r_qt1209h.pdf
8. Aruna Viswanatha, "U.S. Senator urges tough cross-border rules for swaps trading," Reuters, April 24, 2013.
9. Stephen Clapp, "Prospects for 2013 Farm Bill seen as dim in light of House budget proposal," Food Chemical News, March 22, 2013.
10. 12 USC 1843(k)(1)
11. 12 USC 1843(o)

Their financial resources vastly exceed those of the commercial hedgers trading physical commodities and logically, FHC weight of money is far more price influential than that of commercial hedgers. It is very difficult to demonstrate statistically, for example, price co-movement between Goldman's oil trades and its oil derivatives contracts, because FHCs are not required to disaggregate and report their physical trades separately from their derivatives trades.

If the Fed does not end the permission for the FHCs to trade physical commodities, the Senate should authorize the CFTC and the Fed to issue Special Calls for both physical trade and commodity derivatives trade data for 2007–12. The congress should require the CFTC and the Federal Reserve to carry out studies on specific commodities to determine whether the physical trading that is "complementary" for the FHCs results in price distortion or otherwise violates the CEA. As a result of the studies, the CFTC and Fed should also be required to present a joint recommendation to Congress on whether the "grandfathering clause" and related legislation should be terminated or revised.

Accurate, comprehensive, timely and uniform coding of trading data to enable efficient CFTC surveillance

It is important to remember that the DFA responded not just to deregulation of the financial and commodity markets, but to broad exemptions from trade data reporting, e.g., the Enron Loophole, which allowed OTC dealer-brokers to claim that there was and is no evidence of market manipulation or excessive speculation in OTC markets. The OTC counterparty and broader economic devastation that resulted from the implementation of the Commodity Futures Modernization Act of 2000 (CFMA) was partly due to the lack of crucial protections for professional counterparties. The DFA extended requirements for accurate, timely and comprehensive reporting of futures trades in the CEA to include mandatory reporting of OTC trades and trades on "exempt markets," such as the Intercontinental Exchange. Only if all pre- and post-trade data is available to all market participants and regulators simultaneously, in near–real time, can markets become fair and transparent.

As a result of the DFA's OTC trade data reporting requirements, OTC dealer brokers have moved a portion of their OTC products to the futures exchanges, rather than trade them under the rules for Swaps Execution Facilities.[12] This phenomenon, sometimes called the "futurization of swaps," has resulted in a greater degree of pre and post-trade data transparency over a broader range of transactions. ("Futurization" is not an unmitigated good. For example, highly risky credit defaults swaps are now traded on futures markets.[13]) Exchanges report futures trades to regulators in a standardized format every 15 minutes. However, OTC dealers claim that their trades are so "customized" to their clients' needs that they cannot be reported in the comprehensively, accurate and timely fashion, required of futures contracts in all asset classes. As a result, according to CFTC commissioner Scott O'Malia, the lack of uniformity in OTC trade reporting makes it impossible for CFTC regulators to do comprehensive trade data surveillance.[14] Indeed, so idiosyncratic was the coding of the JP Morgan "London Whale" trades that Commissioner O'Malia says that CFTC regulators still cannot find some of the trades.

12. Jamila Trindle, "Crackdown On Swaps Boost [sic] Futures," Dow Jones, January 30, 2013.
13. http://online.wsj.com/article/SB10001424127887324010704578414321303917496.html?KEYWORDS=katy+burne
14. Shahien Nasiripour, "CFTC faces data problem on swaps," Financial Times, March 19, 2013.

IATP believes that if the CFTC allows an OTC contract or a financial derivative product to be "entered into trade," one condition for doing so is that OTC broker dealers must conform to a uniform trade reporting format. The committee should recommend to the Senate that the CFTC be authorized to begin a rulemaking process to ensure uniformity of OTC derivatives reporting to enable accurate, comprehensive and timely pre- and post-trade data surveillance.

High-frequency trading

The "flash crash" of May 6, 2010, triggered by high-frequency trading (HFT) algorithms, is notorious for its effect on equity prices.[15] Because negotiations on the DFA were substantially completed prior to this "flash crash," the DFA provides no explicit authorities to regulate HFT. However, the subsequent flash crashes affecting a broad range of asset classes has resulted in at least one Senate banking committee hearing during which ideas were presented to regulate HFT were discussed.[16] Indeed, a study co-authored by the CFTC's chief economist concluded, with qualifications, that HFT drained liquidity from the market rather than adding it, supposedly the main justification for HFT.[17]

Perhaps less known than the HFT effect on equity prices are agricultural commodity price "flash crashes."[18] For both commodity producers and commercial hedgers, HFT-induced volatility makes it impossible to use price risk-management tools effectively. When commodity index funds are transacted through HFT algorithms, the price volatility of the contracts bundled into the fund formula is exacerbated. Price movements in otherwise unrelated contracts, e.g., cocoa and oil, co-move without any supply and demand reason for doing so.[19] For commodity export dependent and for net food import developing countries, the trade revenue and food insecurity consequences of this HFT induced price volatility are particularly devastating.

Despite ferocious resistance from Great Britain—the foreign affiliate locus of many of the most destructive U.S. OTC broker dealer trades, including MF Global, AIG and JP Morgan—European Union legislation to regulate HFT is moving forward.[20] The revised Market in Financial Instruments Directive (MiFID) and its corresponding regulation are far from implemented. However, the Committee and other interested members of the Senate should study the MiFID. The Senate should authorize the CFTC (and the SEC) to produce a study of the effect of HFT on derivatives contracts under its authority. Following discussion of that study, the Senate should consider whether and how to regulate HFT.

Commodity index funds

Commodity index funds bundle up to 24 commodity contracts in a financial derivative product that is sold to large institutional investors, such as pension funds and endowments as part of a portfolio diversification strategy. Unlike commercial hedgers or traditional speculators, index speculation has a very long investment time horizon, as defined by the clients' needs. Index speculators "roll" contracts, not in response to supply and demand fundamentals, but in response to the fund formula. Index speculator weight of money has reduced commercial hedger participation dramatically from

15. Aline van Duyn, Michael Mackenzie and Jeremy Grant, "That sinking feeling," Financial Times, June 2, 2010.
16. e.g., http://www.bettermarkets.com/sites/default/files/Lauer%20Sen%20Testimony%20FINAL%209-20-12_0.pdf
17. Melanie Rodier, "HFT Critics Call CFTC Economist's Study "Groundbreaking"," Wall Street and Technology, December 5, 2012. www.wallstreetandtech.com and Wallace Turbeville, "Cracks in the Pipeline 2: High Frequency Trading, Demos, February 2013.
18. Gregory Meyer, "High-speed commodities traders under crash scrutiny," Financial Times, March 11, 2011.
19. e.g., David Bicchetti and Nicolas Maystre, "The synchronized and long-lasting change on commodity markets: evidence from high-frequency data," Munich Personal RePEc Archive, March 2012. http://mpra.ub.uni-muenchen.de/37486
20. Alice K. Ross, Will Fitzgibbon and Nick Mathiason, "Britain opposes MEPs seeking ban on high-frequency trading," The Guardian, September 16, 2012.

2006–2011, according to a Better Markets study.[21] Furthermore, because index funds are bet long to increase prices regardless of supply and demand, index induced volatility and weight of money have made commodity user and producer price hedging ineffective and too expensive, resulting in the exit of commercial hedgers from the market, e.g., a third of open interest in Chicago Board of Trade wheat contracts.

Some contend that the market itself provides all the price discipline that index traders need, so no regulation specific to indexed investing is needed. The 20-percent decline in commodity hedge fund assets in 2012 is adduced as an example of such market "self-correction."[22] However, this asset decline is the result of failed strategies among traditional speculators. The retreat of pension funds from commodity index funds is a more significant market trend, but it does not signify the end of indexes, just a strategic retreat by dissatisfied investors.[23] The index fund draws on a very small pool of commodity derivatives contracts, compared to the thousands of equity and bond issues which mutual fund managers can use to develop their products. Given the importance of commercial hedging and traditional speculation to food, energy and base metals security, Congress should authorize the CFTC to produce a study to determine whether commodity index funds and indexed trading patterns result in price distortion and otherwise violate the CEA, as amended by the DFA.

CFTC penalties

There has been a lot of press focus on why there have been almost no prosecutions of high-level financial industry officials following allegations of both civil and criminal infractions of U.S. law. The lack of regulator cooperation with investigators, including the Federal Bureau of Investigation's decimated white collar crime units, surely is a factor, but one that applies to all federal financial regulatory agencies.[24] No doubt, the Senate will want to go beyond Senator Levin's hearings into the J.P. Morgan "London Whale" debacle to examine the HSBC decade-long money laundering for Mexican drug cartels, the Libor price-fixing, the ISDA fix, etc., for the purpose of ensuring that line officers in our largest financial organizations are not Too Big to Jail. Relatively small, out of court settlements paid with shareholder money and no admission of guilt are evidently not dissuasive penalties, but are calculated as a cost of Business As Usual.

The Committee should recommend to the Senate that the CFTC be reauthorized to study how fines and other penalties, such as loss of professional licenses and trading bans, might be targeted at corporate officers and their advisors, to make those civil penalties more persuasive. The committee should also authorize the CFTC's enforcement division to have a permanent liaison with the FBI to investigate criminal violations by U.S. registered broker dealers and their clients ("major swaps participants"), and a permanent liaison with Interpol to investigate criminal violations by the foreign affiliates of U.S. registered broker dealers.

CFTC No Action letters should continue to be the predominant enforcement mechanism for minor and occasional infractions of the CEA and DFA, including temporary waivers from compliance with the DFA.[25] The CFTC should continue to educate market participants about changes in the rules and law, and the Congress should appropriate funds for that ongoing education effort. For major

21. David Frenk and Wallace Turbeville, "Commodity Index Traders and Boom/Bust in Commodity Prices," Better Markets, 2011. http://www.bettermarkets.com/sites/default/files/Better%20Markets-%20Commodity%20Index%20Traders%20and%20Boom-Bust%20in%20Commodities%20Prices.pdf

22. Gregory Meyer, Jack Farchy and Javier Blas, "Commodity hudge funds lose 20% of assets," Financial Times, February 6, 2013. www.ft.com/cms/s/0/22bfad2a-7047-11e2-ab31-00144feab49a.html

23. Ianthe Jeanne Dugan, "Pension Funds Cut Back o Commodity Indexes," Wall Street Journal, February 5, 2013.

24. Gretchen Morgenson, "A Bank Crisis Whodunit, With Laughs and Tears," The New York Times, January 29, 2011, summarizes the Financial Crisis Inquiry Commission report.

25. e.g., http://www.cftc.gov/PressRoom/PressReleases/pr6563-13

or repeated violations of the law, the Senate should reauthorize the CFTC to ensure strong and dissuasive enforcement measures. This year the CFTC undertook a record number of enforcement actions.[26] However, a culture of regulatory compliance cannot be created by enforcement measures alone, as the Senate will no doubt make clear when it reauthorizes the CFTC.

CFTC self-funding

The CFTC's Chairman Gary Gensler testified to the House of Representatives that the agency's enforcement capacity will be compromised as a result of the budget sequester.[27] Unless the Congress wishes the CFTC to reduce its enforcement of the CEA and DFA, it should grant the CFTC authorities to establish a self-funding mechanism financed by fees from CFTC registered U.S. entities and foreign affiliates that trade in U.S. markets. The self-funding basis of other financial regulators, such as the Federal Reserve Bank and the Federal Deposit Insurance Corporation, enables greater consistency and continuity in implementation and enforcement activities. A self-funded CFTC will be better able to train and retain employees whose skills and experience might be lost in an inadequately resourced agency. In order for the self-funding mechanism to generate adequate revenue for the CFTC, the Congress should decide on a phased in combination of self-funding revenues and appropriations.

Cross-border application of the DFA

Even before the CFTC began discussing guidance to industry on how it would implement the DFA requirement for "comparable comprehensive oversight" in foreign jurisdictions, the industry responded with both barely veiled threats and with complaints about a loss of "competitiveness" against OTC dealer brokers operating from foreign jurisdiction. Goldman Sachs CEO Lloyd Blankfein warned EU (and implicitly U.S.) regulators, "Operations can be moved globally and capital accessed globally."[28] This statement in isolation is a matter of fact. However, in the context of the global lobbying campaign against the cross-border application of the DFA to foreign affiliates of U.S. OTC dealer brokers, the statement points to the necessity of the cross-border cooperation among national jurisdictions precisely to ensure that capital moved at the touch of a keystroke is not moved in instruments designed to evade national jurisdictions. It perhaps goes without saying that bank lobbyists complain to regulators in other jurisdictions that their banks will suffer competitive disadvantage with U.S. banks if they are "too tightly" regulated.

There have been numerous letters from foreign regulators and from banks appealing to CFTC Chairman Gary Gensler to reduce the cross-border application of the DFA to a mutual recognition of high-level principles of regulation.[29] The principles of the International Organization of Securities Commissions (IOSCO), a public-private entity headquartered in Madrid, are sometimes invoked as the model for cross-border regulation, most recently in an April 18 letter to Secretary of the Treasury Jacob Lew, a copy of which was sent to you.

However, the IOSCO principles are recommendations to member governments and exchanges and do not carry even the legal effect of "soft law." In practice, reliance on mutual recognition by governments of principles of regulation with no legal force would be an iteration of the industry's

26. "U.S. CFTC breaks agency record for number of enforcement cases," Reuters, October 5, 2012.
27. "Testimony of Chairman Gary Gensler before the U.S. House Appropriations Subcommittee," April 12, 2013. http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-139
28 Cited in Patrick Jenkins and Megan Murphy, "Goldman in Europe warning," Financial Times, September 30, 2010.
29. "Inter-jurisdictional Regulatory Recognition: Facilitating Recovery and Streamlining Regulation," EU-US Coalition on Financial Regulation, June 2012. http://www.sifma.org/issues/item.aspx?id=8589939089

international "self-regulation." Under the mutual recognition scenario proposed by industry, "light touch" regulation would continue, out of fear expressed recently by the chief of enforcement in the Department of Justice, that enforcement of the law against the Too Big to Fail would bring unacceptable "collateral damage."[30]

According to Simon Johnson, a former chief economist at the International Monetary Fund, foreign regulators and central bankers told him that cross-border regulation would occur "never" or "not in my lifetime."[31] These officials alleged that cross-border regulation, such as that proposed in the CFTC guidance, would violate national sovereignty. While the merits of that argument are readily rebuttable, regulators need accurate and timely data to ensure that the DFA objectives, including prevention of cross-border OTC swaps damage to the U.S. economy, are met. The sovereignty argument applied to global, cybernetic trading (except for the aforementioned bank trading of physical commodities) does not prevent these same officials from calling for a financial services chapter in the Transatlantic Trade and Investment Partnership.[32] Sovereignty is ceded to some degree in all trade and investment agreements.

One way for the Senate to support the cross border application of the DFA against sovereignty claims is to authorize the CFTC to test the extent to which regulators in other jurisdiction effectively have sovereign control over the foreign affiliate swaps of U.S. dealer brokers. The Senate should provide additional authorities to the CFTC to deny access to those firms registered with foreign boards of trade from jurisdictions that do not provide unfettered and timely access for the CFTC to review foreign affiliate swaps data of U.S. OTC broker dealers. If the CFTC had access to such data and if that data were uniformly reported in near real time, perhaps the agency could have helped to prevent the damage to the U.S. economy by the foreign swaps of AIG, JP Morgan, MF Global, Goldman, etc.

In its cross-border guidance, the CFTC does not dictate that foreign regulators should give up their sovereign prerogatives to regulate: the CFTC only asks for unfettered and timely access to foreign Swaps Data Repositories to verify that the foreign affiliate swaps of U.S. dealer brokers and their counterparties do not violate the CEA and the DFA. The Senate should reauthorize the CFTC to support this necessary cross-border data verification process. And it should support CFTC negotiations on foreign regulator access to the U.S. OTC trade data for the U.S. affiliates of foreign OTC dealer brokers. Reciprocity is requisite for all effective cross-border regulatory cooperation.

Conclusion

Given the DFA authorities and the grim results of the CFMA deregulation, the terms of the 2013 CFTC reauthorization are crucial for a sustainable recovery of the U.S. economy. We thank the Committee again for the opportunity to express these views and would be pleased the assist the Committee in its reauthorization work.

30. Taibbi, Op cit.
31. Simon Johnson, "Big Banks' Tall Tales," Gulf Times, April 26, 2013. http://www.gulf-times.com/opinion/189/details/350483/big-banks%E2%80%99-tall-tales
32. Jim Brunsden, "EU's Barnier Said to Urge Lew to Rethink Finance Laws," Bloomberg, April 8, 2013.

INSTITUTE OF INTERNATIONAL BANKERS

299 Park Avenue, 17th Floor
New York, N.Y. 10171
Direct: (646) 213-1147
Facsimile: (212) 421-1119
Main: (212) 421-1611
www.iib.org

Sarah A. Miller
Chief Executive Officer
E-mail: smiller@iib.org

May 1, 2013

The Honorable Debbie Stabenow
Chairwoman
Committee on Agriculture, Nutrition and Forestry
United States Senate
Washington DC, 20010

The Honorable Thad Cochran
Ranking Member
Committee on Agriculture, Nutrition and Forestry
United States Senate
Washington DC, 20010

Dear Chairwoman Stabenow and Ranking Member Cochran:

The Institute of International Bankers (IIB) appreciates the opportunity to provide recommendations as the Committee begins to consider the reauthorization of the Commodity Futures Trading Commission (CFTC). As discussed below, our recommendations focus on certain aspects of swaps regulation under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA). The IIB represents internationally headquartered financial institutions from over 35 countries around the world, and its members are extensively involved in activities regulated by the CFTC, including in particular swaps activities that are subject to the requirements of Title VII. Indeed, IIB members constitute approximately half of the firms that are currently registered as swap dealers under Title VII.

We respectfully urge the Committee to take into consideration the recommendations outlined below in order to (i) provide certainty with respect to the application of the requirements of Title VII to cross-border swaps activities and enable effective and efficient coordination and harmonization of U.S. rules with those of other countries in furtherance of the principles adopted by the G-20; and (ii) ensure national treatment for the U.S. operations of foreign banks vis-à-vis U.S.-headquartered banks in connection with their swaps activities in the United States.

INSTITUTE OF INTERNATIONAL BANKERS

<u>Cross-Border Swaps Activities – Certainty in the Coordination of U.S. and International Rules</u>

1) A substantial majority of swaps transactions are effected between counterparties in different countries. Insuring proper alignment of U.S. rules with those of other countries therefore is crucial to maintaining the vitality of the U.S. swaps market.

   <u>Substituted compliance</u> is an important component of harmonizing U.S. swaps rules with the rules of other jurisdictions. Reflecting the strong U.S. commitment to the principles agreed to by the G-20 leaders in 2009, DFA Sec. 752 directs the CFTC to consult and coordinate with its regulatory counterparts outside the United States in order to promote effective and consistent global regulation of swaps. The cross-border dimensions of swaps regulation are also addressed in DFA Sec. 722(d), which establishes a general prohibition against the application of Title VII's requirements to swaps activities outside the United States, except with respect to activities that have a "direct and significant connection with activities in, or effect on, commerce of the United States" or as may be necessary to avoid evasion of Title VII.

   Unfortunately, efforts to this point to achieve an appropriate cross-border harmonization of Title VII's requirements with those of other countries have born little fruit. As a result, there remains considerable uncertainty regarding the cross-border application of Title VII's requirements, which in turn has given rise to significant concerns regarding the prospect of fragmenting and disrupting the international swaps market.

   Mutual recognition of each other's rules through substituted compliance is an important means to accommodate the rules of different countries in a manner that fosters coordination and avoids unnecessary duplication or conflict. Consistent with international comity principles, permitting a financial institution to comply with equivalent rules of another jurisdiction in connection with its cross-border swaps activities best achieves the purposes underlying DFA Sections 752 and 722(d).

   At this stage of Title VII's implementation, there exists a very real potential for conflict between U.S. rules and those of other countries. Absent a satisfactory resolution of these conflicts, many global swap dealers will face the untenable position of violating one country's rules or laws in order to comply with another's. **We believe it is essential to make it explicitly clear that reliance on broadly equivalent rules of other countries is an integral part of the cross-border swaps regulatory regime intended under Title VII.**

<u>Ensuring National Treatment</u>

2) <u>DFA Sec. 716</u>, also known as the "swap push-out rule", contains an acknowledged oversight that results in unequal treatment for uninsured U.S. branches and agencies of

INSTITUTE OF INTERNATIONAL BANKERS

foreign banks compared to that of U.S. banks. Sec. 716 sets forth a general prohibition against "Federal assistance" (including access to the discount window) for swap entities, but includes certain grandfather and transitional provisions that permit the phased-in implementation of the prohibition with respect to insured depository institutions as well as safe harbor provisions that allow insured depository institutions to continue to engage in swap activities related to their bona fide hedging and traditional bank activities. The uninsured branches and agencies of foreign banks are not afforded the benefit of these provisions. Senators Dodd and Lincoln recognized that this exclusion was unintentional and acknowledged that there was a need "to ensure that uninsured U.S. branches and agencies of foreign banks are treated the same as insured depository institution."[1]

Uninsured U.S. branches and agencies are licensed by a federal or state banking authority and subject to the same type of safety and soundness examination and oversight as U.S. banks. Based on the policy of national treatment, uninsured branches and agencies are afforded equivalent treatment to U.S. banks, including access to the Federal Reserve's discount window. Access to the discount window is an important tool for maintaining a sound and orderly financial system, and the branches and agencies of U.S. banks are provided access to similar facilities in other countries.

Based on the disparate treatment to which they are subject under Sec. 716, the uninsured U.S. branches and agencies of foreign banks are facing the prospect of having to "push out" all their existing swap positions and ongoing swap activities to a registered swap affiliate by the July 16, 2013 effective date –an impossible compliance task and one that places these uninsured branches and agencies at a substantial competitive disadvantage vis-à-vis insured depository institutions that benefit from the grandfather, transitional and safe harbor provisions. **The resulting disparity is wholly at odds with the longstanding U.S. policy of national treatment, and therefore we would urge the Committee to address this important issue.**

3) The <u>definition of a "Swap Dealer" under Sec. 1(a)(49) of the CEA</u> (as modified by the DFA) provides an exclusion for insured depository institutions, specifying that in "no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer." Similar to the unintended omission of uninsured U.S. branches and agencies of foreign banks in DFA Sec. 716, this exclusion is provided only for insured depository institutions and results in unequal treatment for those uninsured branches and

---

[1] 156 Cong. Rec. S5903-S5904 (daily ed. July 15, 2010) (colloquy between Senator Dodd, Chairman of the Senate Banking Committee, and Senator Lincoln, Chairman of the Senate Agriculture Committee and sponsor of Sec. 716).

INSTITUTE OF INTERNATIONAL BANKERS

agencies that generally enter into swaps transactions only in connection with their lending activities. [2]

This exclusion permits small U.S. banks the ability to enter into interest rate swaps in connection with their lending activities without having to register as swap dealers, thereby providing them a competitive advantage over the similarly-situated uninsured U.S. branches and agencies of foreign banks, which are denied this parity of treatment. **We would urge the Committee to address this important national treatment issue.**

We thank you for your attention to our recommendations and are happy to provide additional information at your request.

Sincerely,

Sarah A. Miller
Chief Executive Officer

[2] For those insured depository institutions that generally enter into swaps transactions with customers only in connection with their lending activities, the exclusion ensures that such ordinary course banking activities will not result in their having to register as a swap dealer. At the same time, swap transactions conducted by an insured depository institution outside the context of its ordinary banking activities may result in it having to register as a swap dealer.

ice

May 1, 2013

VIA EMAIL

The Honorable Debbie Stabenow
Chairwoman

The Honorable Thad Cochran
Ranking Member
United States Senate Committee on
Agriculture, Nutrition and Forestry
328A Russell Senate Office Building
Washington, DC, 20510

Dear Chairwoman Stabenow and Ranking Member Cochran:

Thank you for your letter inviting the IntercontinentalExchange (ICE) to provide input as the Senate Committee on Agriculture, Nutrition and Forestry prepares to reauthorize the Commodity Exchange Act (CEA). ICE has appreciated the opportunity to work with the Senate Committee on Agriculture in the past on important matters affecting the commodity markets and the risk management industry.

As you note, CEA reauthorization is a key opportunity for Congress to review the law as well as the oversight of the Commodity Futures Trading Commission (CFTC). This responsibility takes on a new importance in the wake of recent futures commission merchant bankruptcies and the implementation of a new regulatory regime for the swaps markets provided for by the Dodd-Frank Act.

We will continue to engage you and your staff regularly on the wide variety of CEA-related issues under the Committee's jurisdiction and any new issues that could arise as the CFTC completes its Dodd Frank rulemaking. In response to your request, we suggest specific areas where ICE would like to work with the Committee to develop proposals during the reauthorization process:

- **Customer protection and Bankruptcy Code Reform**
  Large FCM insolvencies have left end-users exposed to financial losses and lengthy work out periods under a trustee authorized by the Securities Investor Protection Act. Without a fix to the bankruptcy code, a CFTC regulation meant to improve the protection of customer funds by keeping them legally segregated but permitting them to be commingled for operational purposes—the LSOC rule—may not offer portability of customer funds post default as intended. The Committee also needs to consider what changes to the role of the designated self-

ICE

regulatory organization and even federal bankruptcy law may be necessary to prevent such situations from reoccurring.

- **CFTC Staff Structure**
  The Dodd-Frank Act conferred significant new responsibilities on the CFTC. Staff operations and reporting structures should be reviewed to ensure the agency runs as efficiently as possible in its enhanced role.

- **Inter-Agency Cooperation**
  In many critical instances, Dodd-Frank requires the CFTC and other independent agencies to work together on joint rulemakings but lacks a mechanism to ensure such rulemakings are achieved in a timely way.

- **Global Regulatory Harmonization**
  The CEA needs to reflect the global nature of commerce and the risk management business. Otherwise we risk the creation of disparate regulatory regimes across jurisdictions that will ultimately only lead.

We are discussing these areas internally and hope to develop specific legislative proposals that may be useful to you and your staff in your development of the draft legislation.

Thank you again for your outreach. ICE looks forward to working with the Committee on the reauthorization process.

Yours truly,

Jeffrey C. Sprecher
Chairman and Chief Executive Officer
IntercontinentalExchange, Inc.

Testimony before the U.S. Senate Committee on Agriculture,
Nutrition & Forestry

"Reauthorization of the Commodity Futures Trading Commission"

Written Testimony

William Dunaway
Chief Financial Officer
INTL FCStone, Inc.

July 17, 2013

Chairman Stabenow, Ranking Member Cochran, thank you for permitting me to submit written testimony for the record. I serve as the CFO of both, FCStone, LLC a registered FCM, and INTL Hanley, LLC, a registered, Swap Dealer, as well as their publicly-traded parent, INTL FCStone. INTL Hanley was one of the first to register as a Swap Dealer under Dodd-Frank, and we were the first non-bank to register.

Dating back to 1924, INTL FCStone is now a global firm that services more than 20,000, mostly mid-sized commercial customers who are producers and end-users of virtually every major traded commodity. The largest market we serve is agriculture. Our customers handle about 20% of the grain production in Texas, 40% in Kansas, and 50% of grain production in Iowa and Oklahoma.

Support for Dodd-Frank

INTL FCStone supports the Dodd-Frank Act. However, there are rules implementing the Act that may prohibit end-users from utilizing our products to hedge their risk. Other proposals, if unchanged, could push independent firms like INTL FCStone out of the market, leaving thousands of smaller end-users with nowhere to turn for hedging.

Capital and Margin Requirements – Swap Dealer Issues

In our conversations with CFTC staff about the capital and margin rules, we have learned that our non-bank Swap Dealer may be required to hold regulatory capital up to hundreds of times more than a bank-affiliated Swap Dealer must hold for the same portfolio of positions. Other non-bank commodity Swap Dealers will be in the same disadvantaged position.

There are two reasons for this discrepancy. First, under the new rules, bank-affiliated Swap Dealers can use internal models to calculate the risk associated with customer positions. Non-banks cannot. Internal models allow more sophisticated netting of commodity positions to determine market risk capital charges. The CFTC's approach will permit only limited netting for non-bank dealers, forcing non-banks to hold capital against economically offsetting commodity swap positions. This means higher capital requirements overall, and relative to those of a bank-affiliated dealers using internal models.

In addition the CFTC's approach relies on Basel II, which treats commodity derivatives more harshly than other types of derivatives when calculating risk. As a result, the same derivatives portfolio that would require a bank-affiliated Swap Dealer to hold $10 Million in regulatory capital would require us to set aside up to $1 Billion in capital.

This is entirely unsustainable, and will cause non-bank Swap Dealers to exit the business. The direct result will be higher costs for end-users, and then for consumers. Increasing concentration in the industry until only the big banks are left will leave many smaller end-users with no place to go.

It is not too late to fix this. The Commodity Exchange Act ("CEA") requires regulators to maintain "comparable" minimum capital requirements for all Swap Dealers. We believe that the CFTC should revise its proposed capital rules to ensure that the requirements applicable to non-bank and bank-affiliated Swap Dealers are "comparable" by altering the non-bank rules to: allow full netting of offsetting commodity swap positions; allow "matched positions" offsetting; or permit all Swap Dealers to use internal models.

If the CFTC fails to make these changes, we request that this Committee codify one or more of these alternatives as part of the CEA reauthorization.

Capital and Margin Requirements for FCMs – Residual Interest / Customer Funds

Turning to our FCM, the CFTC has proposed rules requiring that an FCM's residual interest exceed margin deficiencies at all times, and to reduce the margin call collection period to one day. These rules will have a substantial negative impact on some customers' ability to hedge their commercial risks, and will severely challenge small and mid-sized FCMs' continued operation. The CFTC should study these issues and conduct a cost-benefit-analysis before proceeding.

Residual Interest

It is simply not feasible for FCMs to determine whether margin deficiencies are present at all times throughout a day. Therefore, FCMs will have to hold margin that assumes the failure of ALL customers, EVERY day. Such a worst-case scenario is unheard of, and is not applied to any other financial entities. Under the new rule, FCMs will require customers to put up more money at all times, possibly doubling margin requirements, and likely resulting in customers being required to pre-fund their margin.

One-Day Margin Call

In addition, we feel the Commission's proposal mandating what amounts to a one day margin call collection period for FCM customers, as opposed to the current three business days, is not realistic. Our customers include a large number of farmers and ranchers who meet margin calls by using checks. They may be required to double or triple their margin payments to be able to meet the one-day payment requirement.

Many of our customers also finance their margin calls, requiring more time to arrange wire transfers. Foreign customers have time zone differences that make the one day deadline impossible. We strongly believe that a two-day deadline is more reasonable and equitable for our customer base.

External Business Conduct Requirements

As a result of the External Business Conduct Rules now in effect, many of our customers have abandoned OTC derivatives, even though OTC is their most effective hedging tool, because the paperwork requirements are simply too burdensome. Others have asked us to refrain from providing a mid-market mark because they can either derive this information themselves, or prefer immediate execution at the market price and cannot afford even seconds delay in execution.

We believe that staff "No Action" letters from the CFTC are not an appropriate long-term solution for this issue. The proposed rules on capital and margin allow customers to opt-in or opt-out of certain protections, including the segregation requirement. We ask that this same option be extended to certain Business Conduct Rule disclosures.

Extraterritorial Application of Dodd Frank

Like most other market participants, INTL FCStone is also concerned about the international reach of Title VII of the Dodd-Frank Act. The CFTC has issued proposed rules and now a final guidance that would essentially grant the broadest possible extraterritorial reach to U.S. swaps regulations, based on a broad definition of a "U.S. Person."

This issue is of great concern to INTL FCStone because our largest geographic area of growth for our OTC swaps is Brazil. Brazil is a fast-growing, but still developing market that desperately needs good hedging tools. But, if local agriculture producers in Brazil have to comply with Dodd-Frank requirements when hedging with us and do not have any comparable requirements or burdens if they hedge with a non-U.S. firm, they will go with the non-U.S. firm.

The SEC's proposal is the preferable option at this point, especially with respect to the broad view taken by the SEC on the issue of substituted compliance. We are heartened by the recent "Path Forward" on cross-border issues agreed to by the U.S and the E.U., and we hope the U.S. and E.U. regulators will move toward a workable solution where non-U.S. rules that attempt to address the same issues and get to the same end point as U.S. rules are deemed comparable. But we also hope that the U.S. regulators anticipate entering into similar agreements with regulators in Asia and South America in a timely manner.

"Futurization of Swaps"

Finally, I want to address an issue that has been called the "Futurization of Swaps." We have been told by a number of our customers that they have determined that they will no longer use "vanilla" or "look-alike" OTC instruments, and instead will rely exclusively on exchange traded futures. But, this decision has not been the result of a considered decision about which instrument serves as the most cost-effective risk management tool, but instead, is wholly the result of the regulatory burdens associated with swaps as opposed to futures.

Although exchange-traded futures are often an appropriate and suitable risk management tool, there are other instances where futures may not be as beneficial from the customer's perspective. In our experience, for farmers and others in the agriculture space, vanilla OTC in fact may be the most cost-effective and practical hedging vehicle available to them.

Conclusion

INTL FCStone is not interested in dismantling Dodd-Frank. In fact, most of the concerns I have outlined here today are about the implementation of the rules, not the Act itself. We are simply trying to ensure that the final rules function as intended and commercial end-users and the firms like INTL FCStone who serve them, do not face greater regulatory burdens than those in the markets who speculate and create systemic risk.

Department of Water and Power the City of Los Angeles

ANTONIO R. VILLARAIGOSA
Mayor

Commission
THOMAS S. SAYLES, President
ERIC HOLOMAN, Vice President
RICHARD F. MOSS
CHRISTINA E. NOONAN
JONATHAN PARFREY
BARBARA E. MOSCHOS, Secretary

RONALD O. NICHOLS
General Manager

May 1, 2013

The Honorable Debbie Stabenow
Chairwoman
Committee on Agriculture, Nutrition and Forestry
United States Senate
Washington, D.C.20510

The Honorable Thad Cochran
Ranking Member
Committee on Agriculture, Nutrition and Forestry
United States Senate
Washington, D.C.20510

Dear Chairwoman Stabenow and Ranking Member Cochran:

The Los Angeles Department of Water and Power (LADWP) appreciates this opportunity to provide input to the Agriculture Committee about the reauthorization of the Commodity Futures Trading Commission (CFTC) and the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). Specifically, we are concerned that the CFTC's interpretation and implementation of the Dodd-Frank Act unnecessarily hampers the ability of public power utilities to use swaps to hedge commercial risk. As the nation's largest municipal water and power utility, LADWP depends on the ability to use swaps to procure fuel and provide reliable electric energy at reasonable and stable prices in order to fulfill our public service obligations to our over 4 million consumers.[1]

Under the Dodd-Frank Act, entities that are defined as swap dealers or major swap participants are subject to a myriad of CFTC regulations such as registration requirements, business conduct standards, clearing and exchange trading, capital and margin requirements, position limits, and various reporting and recordkeeping duties (collectively "swap regulations"). The Dodd-Frank Act also imposes certain requirements on swap dealers and major swap participants transacting with "special entities," which are defined in the statute to include among other entities, a State, State agency, city, county, municipality, or other political subdivision of a State. As a municipally-owned utility, LADWP is considered a special entity under the Dodd-Frank Act.

The CFTC provided that anyone entering into more than a de minimis amount of transactions with special entities (currently $800 million per year, but it was set in the final rule as $25 million) will be subject to the swap dealer regime. A different and much higher de minimis threshold (currently $8 billion per year), however, was set as the "swap dealer" trigger for transactions with entities that are not special entities, such as

[1] LADWP was established more than 100 years ago to deliver reliable, safe water and electricity to 4 million residents and businesses in the City of Los Angeles. LADWP provides its 666,000 water customers and 1.4 million electric customers with quality service at competitive prices. A five-member Board of Water and Power Commissioners establishes policy for the LADWP, which is a revenue-producing proprietary department of the City of Los Angeles.

privately-owned utilities and cooperatives. While LADWP understands the general motivation behind a policy to protect special entities, in this case, the differentiation between special entities that are public power utilities and other utilities - both of which have public service obligations - is not justified, increases operational risks, and imposes economic disadvantages.

LADWP is governed by a Board of Commissioners, a 15-member full-time City Council and a Mayor. The governance oversees a strong Risk Management Policy and independent auditor review. As a utility with jointly-owned generating and transmission facilities in seven western states, and one of the most aggressive renewable energy programs in the country, the annual fuel and purchased power budget exceeds $1.5 billion. Many of these utility facilities are jointly-owned with Investor-Owned Utilities (IOUs) that are not special entities. LADWP and the IOUs (collectively, the "Parties") enter Inter-Party agreements to manage operations and hedge risks. Having a different regulatory paradigm for hedging creates the potential for violations and is now limiting the Inter-Party and joint transaction options that previously existed between the Parties. The special entity sub-threshold is stranding some of the value of these historical investments and relationships between LADWP and the IOUs because IOUs working with LADWP do not want to have to register or risk registering as swaps dealers.

LADWP maintains that municipally-owned utilities have the same expertise in hedging price risks as other utilities, and therefore should be treated the same when it comes to swaps. Many of our current counterparties are nonfinancial entities (such as IOUs, independent producers, and natural gas suppliers) engaged in the electric and natural gas industry in the same geographic area as we are. These counterparties have indicated that they want to avoid the risk of tripping over the special entity sub-threshold and having to register as a "swap dealer." These counterparties can rely on a much higher safe harbor threshold of $8 billion (which eventually will phase down to $3 billion) when transacting with IOUs or cooperative utilities than with special entities. The protection intended by the CFTC in establishing the lower, currently $800 million sub-threshold in fact puts special entity utilities at a competitive disadvantage to other utilities by hindering our ability to hedge operational risks.

The lower de minimis sub-threshold will make it harder for special entity utilities to find willing nonfinancial counterparties that can provide needed market competition and highly customized and regional products that "Wall Street" firms are unable or unwilling to provide. If we cannot cost-effectively hedge our commercial risks, consumers will confront more volatile and higher rates for energy or, even worse, face risks to their electric grid reliability.

The comments submitted to this Committee by the American Public Power Association (APPA) and Large Public Power Council (LPPC), groups of which LADWP is a member, outline the efforts that have been undertaken to petition the CFTC to amend the swap-dealer rule to exclude utility special entities' utility operations-related swap transactions from counting towards the special-entity threshold. The CFTC's response to these efforts was an October, 12, 2012, no-action letter that allows a counterparty to deal in up to $800 million in swaps (instead of $25 million) with government-owned utilities without being required to register as a swap dealer. While we appreciate the CFTC's attempt to address the problem, the solution provided in the October 2012 no-action letter has proven insufficient.

On November 19, 2012, APPA and LPPC submitted a letter to the CFTC explaining our concerns with the no-action letter fix and reiterating the need for effective relief as requested in our July 12, 2012, petition.[2] Although some of the CFTC commissioners have voiced agreement that more effective relief is appropriate, it has become apparent that without a legislative fix there may be no real relief for public power entities like LADWP.

LADWP strongly encourages the Senate Agriculture Committee to include a legislative solution to address the utility special entity sub-threshold problem as part of CFTC reauthorization or as a stand-alone bill. The Committee may wish to consider the Public Power Risk Manage Act of 2013 (H.R. 1038), which was introduced by Congressmen Doug LaMalfa (R-CA), Jim Costa (D-CA), Jeff Denham (R-CA), and John Garamendi (D-CA) and House Financial Services Committee member Blaine Luetkemeyer (R-MO) and reported out by the House Agriculture Committee on March 20, 2013, as a framework for its solution. .

Without a legislative fix, the current $800 million sub-threshold will leave government-owned utilities, which need to hedge commercial risks of their energy operations in the same way as other utility providers, as hostage counterparties to large financial institutions, or in some cases without any available counterparties. We appreciate your consideration of our concerns and look forward to working with you to ensure an effective solution.

Respectfully Submitted,

By: Randy S. Howard

RANDY S. HOWARD
Chief Compliance officer – Power System
Los Angeles Department of Water and Power
111 North Hope Street, Suite 921
Los Angeles, CA90012
Telephone Number: (213) 367-0381
Email: Randy.Howard@ladwp.com

[2]November 19, 2012 Letter available at:
http://www.lppc.org/issues/cftc/LPPC_CFTC_Letter_to_Chairman_Gensler_November_19_2012.pdf

MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

April 30, 2013

Via Electronic Mail: cftcreauthorization@ag.senate.gov

The Hon. Debbie Stabenow
Chairwoman
Committee on Agriculture, Nutrition and Forestry
U.S. Senate
Washington, DC 20510-6000

The Hon. Thad Cochran
Ranking Member
Committee on Agriculture, Nutrition and Forestry
U.S. Senate
Washington, DC 20510-6000

Re: Reauthorization of the Commodity Futures Trading Commission

Dear Chairwoman Stabenow and Ranking Member Cochran:

Managed Funds Association ("**MFA**")[1] acknowledges the receipt of your letter[2] and appreciates the opportunity to provide the U.S. Senate Committee on Agriculture, Nutrition and Forestry (the "**Committee**") with recommendations related to reauthorization of the Commodity Futures Trading Commission ("**CFTC**") to regulate futures, swaps, and options markets pursuant to the Commodity Exchange Act ("**CEA**"). Our members, as investors and market participants in the derivatives markets, have a strong interest in ensuring that the CEA provides a modern regulatory framework to protect customers and foster economic growth. Accordingly, we respectfully submit a number of recommendations, which we believe will strengthen the CEA, and thereby, the markets and financial stability.

[1] Managed Funds Association represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

[2] Letter from Debbie Stabenow, Chairwoman and Thad Cochran, Ranking Member, Committee on Agriculture, Nutrition, and Forestry, United States Senate, to Richard Baker, President and Chief Executive Officer, MFA, March 7, 2013.

600 14th Street, NW, Suite 900 | Washington, DC 20005 | 202.730.2600 | Fax 202.730.2601 | www.managedfunds.org

I. Dodd-Frank Act-like Protections for Sensitive or Proprietary Information

A. Reports of Commodity Pool Operators and Commodity Trading Advisors

MFA believes that Congress should strengthen the confidentiality protections for proprietary data in possession of the CFTC. MFA consistently has supported reasonable reporting requirements to ensure that regulators have meaningful data upon which to make policy decisions. Strong confidentiality protections help foster an atmosphere of trust to ensure that reporting entities are as forthcoming as possible. As you know, market participants—whether hedgers or investors—invest significant research, time and resources into developing proprietary hedging or investment strategies. Such trading strategies are trade secrets; the CEA and other statutes have recognized the legitimate commercial need to protect the confidentiality of such secrets.[3] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") in providing regulators with new authorities to collect sensitive and proprietary data also included important provisions to ensure that the confidentiality of such information was fully protected.

MFA believes that the confidentiality protections under section 8 of the CEA should be further enhanced to be consistent with these important protections in the Dodd-Frank Act.

The Dodd-Frank Act created the Financial Stability Oversight Council ("**FSOC**"), requiring the members of FSOC, including the CFTC, to collect sensitive and confidential data for the purpose of assessing financial stability. The Dodd-Frank Act included important provisions directing FSOC members to maintain the confidentiality of such data.[4] Specifically, the Dodd-Frank Act amended the Investment Advisers Act of 1940 ("**Advisers Act**")[5] to protect the confidentiality of reports that the Securities and Exchange Commission ("**SEC**") requires for SEC-registered investment advisers. We believe that Congress should make similar Dodd-Frank Act amendments to the CEA for CFTC reports. Such amendments would be appropriate and helpful to ensure that consistent confidentiality protections would extend to the reports, documents, records and information of commodity pool operators ("**CPOs**") and commodity trading advisors ("**CTAs**"). This is particularly important given that the CFTC requires both CPOs and CTAs to file reports that include sensitive and proprietary information.

---

[3] *See* Section 8(a)(1) of the CEA (providing that in connection with investigations that the CFTC "may not publish data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers). *See e.g.*, Freedom of Information Act, 5 USC §552 (b)(4) (exception for "trade secrets and commercial or financial information obtained from a person and privileged or confidential....").

[4] Section 112(b)(5)(A) of the Dodd-Frank Act.

[5] *See* Section 112(b)(5) of the Dodd-Frank Act; and Section 204(b) of the Advisers Act. The amendments to the Advisers Act, among others, provide that: (1) the SEC may not be compelled to disclose any report or information, except that it may not withhold information from Congress, upon an agreement of confidentiality; (2) any department, agency, or self-regulatory organization that receives reports or information from the SEC shall maintain the confidentiality of such materials in a manner consistent with the level of confidentiality established for the SEC by statute; and (3) with respect to any adviser report or materials required to be filed with the SEC, the SEC and any other regulatory entity that receives such report or materials shall be exempt from section 552 of title 5.

The current inconsistency creates two potential difficulties. First, it may expose data from CFTC-regulated entities to greater risk of public disclosure. Second, it creates a potential unlevel regulatory playing field, disadvantaging the CFTC in its efforts to collect, analyze, and share data.[6] To afford confidential information consistent treatment for CPOs and CTAs as well as investment advisers, we recommend that the Committee consider amending the CEA by extending these important Dodd-Frank Act protections for sensitive or proprietary information to CPOs and CTAs.

B. Additional Protections

In addition to the above statutory protections for sensitive or proprietary information, we believe the CFTC also needs to enhance its policies and controls with respect to the use of non-public data and internal controls. For example, we are alarmed at reports that academics have had access to, and have used confidential trading data and trading messages from, the CFTC to reverse engineer trading strategies and to have published their findings in academic journals.[7] We commend CFTC Chairman Gary Gensler for requesting that the CFTC Inspector General investigate this matter.[8] Section 8(a)(1) of the CEA in connection with investigations, as well as Section 552 of the Freedom of Information Act, prohibit disclosure of business transactions/commercial information and trade secrets regardless of whether it is in connection with the identity of the market participant.[9] We believe this disclosure is a fundamental violation of confidentiality and urge the Committee to review the CFTC Inspector General's findings and the steps the CFTC agrees to take to enhance its policies and controls with respect to non-public information.

We also believe that Congress should amend the CEA to strengthen the confidentiality requirements for swap data repositories ("**SDRs**") to protect both the identity of traders and the nature of their trading activities. In particular, our concerns with confidentiality protections extend to swap transaction data that market participants are reporting to SDRs under the CFTC's data reporting rules. Under the CFTC's final SDR rules,[10] an SDR must protect the confidentiality of reported swap data and may not disclose it to market participants. The final SDR rules provide an exception to this prohibited access rule, allowing a party to a particular swap to have access to "data and information" related to such swap. The final SDR rules do not define the broad phrase "data and information". For swaps that are traded anonymously on designated contract markets ("**DCMs**") and swap execution facilities ("**SEFs**") and then cleared

[6] For example, we note that the SEC and CFTC have jointly adopted Form PF for certain reporting obligations. A dually registered entity filing Form PF with the SEC would have greater confidentiality protection than if the entity filed the exact same report with the CFTC.

[7] *See e.g., Academic Use of CFTC's Private Derivatives Data Investigated,* Bloomberg, Mar. 7 2013 available at: http://www.bloomberg.com/news/2013-03-06/academic-use-of-cftc-s-private-derivatives-data-investigated-1-.html; and Exploratory Trading, Adam D. Clark-Joseph, January 13, 2013.

[8] *Id.*

[9] *See supra* n. 3.

[10] CFTC Final Rule on "Swap Data Repositories: Registration Standards, Duties and Core Principles", 76 Fed. Reg. 54538 (Sept. 1, 2011), available at: http://www.gpo.gov/fdsys/pkg/FR-2011-09-01/pdf/2011-20817.pdf.

in accordance with the CFTC's straight-through processing ("**STP**") requirements,[11] the derivatives clearing organization ("**DCO**") or DCM/SEF must report the swap transaction data and information to the SDR, which includes the legal entity identifiers ("**LEIs**") or the "CFTC Interim Compliant Identifiers" ("**CICIs**") of the original counterparties. If an original counterparty has the LEI or CICI of the other original counterparty from the SDR, such original counterparty can also determine its counterparty's identity by accessing DTCC's CICI database utility. This determination, in turn, could allow an original counterparty to a cleared swap to obtain transaction-level data about its original executing party's trades. Such disclosure should be prevented, because it could reveal proprietary information, could be used to introduce non-competitive distortions into the marketplace, and, in particular, could be damaging to the evolution of anonymous trading on DCMs and SEFs. Accordingly, we raised our concerns with Staff in the CFTC's Division of Market Oversight, noting that the loss of counterparty anonymity for cleared swaps is an unintended outcome of the broad reference to "data and information" in the final SDR rules. We have asked CFTC staff to issue formal guidance to clarify that SDR "data and information" that may be accessed by a party to any cleared swap should never include the LEI of its original executing counterparty or that counterparty's clearing member, or any other information that would identify these entities.

We have also become aware of other instances in which the confidentiality of trade data at SDRs has been compromised. We understand that as a result of the failure of confidentiality protections, competitors and other market participants may have had access to, and traded upon the basis of, confidential information. The potential for confidential swap data leakage is heightened when SDRs face inevitable technology malfunctions and internal control deficiencies. In addition to SDR data disclosure risks, we believe the sheer volume of data that the CFTC must begin digesting and analyzing from SDRs presents an opportunity for unprecedented regulatory transparency into the derivatives markets, but also another source of disclosure risk of market participants' LEIs and proprietary trading data if data confidentiality and integrity are not rigorously protected by the CFTC's policies, procedures and internal controls.

Accordingly, we believe the Committee should consider amending the CEA to clarify an SDR's obligations to maintain the confidentiality and integrity of swap trade data and the consequences of failures to perform this obligation. MFA believes that both the CFTC and industry market utilities, such as SDRs, DCOs, DCMs and SEFs, must provide appropriate safeguards to ensure the confidentiality of sensitive market secrets, particularly under circumstances in which regulations require market participants to furnish such data to regulators, SDRs, DCOs, DCMs and SEFs.

II. Protection of Customer Collateral

MFA supports efforts to strengthen the legal framework for customers of futures commission merchants ("**FCMs**") and believes that Congress should amend the Bankruptcy

[11] *See* CFTC Final Rules on "Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management", 77 Fed. Reg. 21307 (April 9, 2012), available at: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-7477a.pdf.

Code to bolster such protection. MFA appreciates that Congress remains vigilant about protection of investors and has held numerous hearings related to the MF Global, Inc. ("**MF Global**") and Peregrine Financial Group, Inc. ("**Peregrine**") insolvencies.[12] Our members are fiduciaries to their investors and are customers themselves. As a result, we were very troubled by the MF Global and Peregrine events because the misuse or misplacement of customer funds in those situations resulted in customers experiencing a delay in the return or loss of substantial amounts of their assets.[13] Accordingly we support thoughtful legislative and regulatory changes to strengthen protections of FCMs' customers.

As the Committee knows, counterparties to swaps transaction must post collateral to ensure performance of the contract.[14] The protection of such collateral is one essential element to preserving the financial integrity of the markets.

Under current law, if an FCM becomes insolvent, it is possible a court might conclude that the customers' collateral is subject to the claims of all the FCM's customers on a *pro rata* basis (*i.e.*, non-defaulting customers would share equally in any shortfall). MFA believes that such treatment defeats the very purpose of collateral, *i.e.*, to provide assurance as to the integrity and performance of individual contracts. To remedy this concern, we urge Congress to amend Chapter 7 of the Bankruptcy Code so that customer assets posted as collateral on cleared derivatives transactions are not considered "customer property"[15] subject to *pro rata* distribution upon an FCM's insolvency. Such an amendment would ensure that a customer receives prompt return of all of its assets upon such insolvency, rather than sharing in any shortfall due to the FCM's or another customer's default.

An amendment to the Bankruptcy Code would also enhance the effectiveness of existing and potential customer segregation protections. For example, the CFTC has adopted the "legally segregated operationally commingled" model ("**LSOC**") for cleared swaps,[16] which is intended

[12] *See e.g.*, Committee hearing "Investigative Hearing on the MF Global Bankruptcy" (December 3, 2011), available at: http://www.ag.senate.gov/hearings/investigative-hearing-on-the-mf-global-bankruptcy; Committee hearing "Examining the Futures Markets: Responding to the Failures of MF Global and Peregrine Financial Group", August 1, 2012, available at: http://www.ag.senate.gov/hearings/examining-the-futures-markets-responding-to-the-failures-of-mf-global-and-peregrine-financial-group.

[13] *See* Complaint, Commodity Futures Trading Commission v. Peregrine Financial Group, Inc., and Russell R. Wasendorf, Sr., No. 12-cv-5383 (N.D. Ill. July 10, 2012), available at: http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfpfgcomplaint071012.pdf. *See also* Report of the Trustee's Investigation and Recommendations, In re MF Global Inc., No. 11-2790 (MG) SIPA (Bankr. S.D.N.Y. Jun. 4, 2012), available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/mfglobaliinvestreport060412.pdf.

[14] On uncleared swap trades, customers post initial margin to their dealer counterparties, and customers and their dealer counterparties exchange variation margin on a daily basis, depending on changes in the value of the swap.

[15] 11 U.S.C. §766.

[16] *See* CFTC final rule on "Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions", 77 Fed. Reg. 6336 (February 7, 2012), available at: http://www.gpo.gov/fdsys/pkg/FR-2012-02-07/pdf/2012-1033.pdf. LSOC requires an FCM to segregate its customers' collateral from its own property, but permits the FCM to commingle in an omnibus account all collateral of its customers.

to protect the assets of non-defaulting customers from *pro rata* distribution. However, LSOC is a new and untested segregation model. If a bankruptcy trustee or FCM's creditors challenge LSOC's intended protections in court after a customer's default leads to an FCM's insolvency, it is possible that a Bankruptcy Court judge will agree and hold that non-defaulting customers' collateral is not "customer property" and is shielded from *pro rata* distribution. If Congress amends the Bankruptcy Code as discussed above, it would help to alleviate this uncertainty and protect customers.

In addition, market participants are continuing to consider other enhancements to customer protections, such as optional full physical segregation of customer collateral.[17] MFA appreciates the CFTC's efforts to enhance customer protections[18] by making valuable regulatory adjustments to reduce the likelihood of events similar to MF Global and Peregrine occurring in the future. However, we emphasize that work remains to ensure that customers receive appropriate and the same level of protections in the cleared market as some currently enjoy in the over-the-counter ("**OTC**") derivatives market. Therefore, MFA believes that, if Congress amended the Bankruptcy Code, it would significantly accelerate and enhance progress of customer protections and ultimately would facilitate customers' ability to customize and choose the level of protection that is appropriate for them.

III. International Aspects of Regulation

A. International Coordination

MFA urges U.S. policymakers and regulators to enhance their coordination with their European, Asian, and other counterparts to ensure that derivatives regulatory reform is consistent, where applicable, and addresses counterparty and systemic risk, while permitting access to, and competition among, central counterparties ("**CCPs**") organized in countries outside of the relevant jurisdiction.

[17] Full physical segregation is an arrangement that allows a customer to put its collateral in an account with a custodian or other third party in the customer's name, rather than have the customer's FCM hold its collateral, and thus, protects the customer in the event that its FCM or another customer becomes insolvent.

MFA notes that, even if LSOC is tested in a Bankruptcy Court proceeding and determined that customers' collateral is not "customer property" subject to *pro rata* distribution, LSOC still relies on the accuracy of an FCM's books and records to be effective. Under LSOC, if the FCM's books and records are not up-to-date or contain errors, an issue remains that there might be a delay in return of customer collateral or customer collateral might incorrectly be designated as FCM or another customer's property. For this reason, market participants continue to pursue full physical segregation options to provide the most robust protection of their collateral.

[18] *See* CFTC notice of proposed rulemaking on "Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations", 77 Fed. Reg. 67866 (November 14, 2012), available at http://www.gpo.gov/fdsys/pkg/FR-2012-11-14/pdf/2012-26435.pdf (proposing to ensure adequate protection of customers and their funds by amending and augmenting the requirements for FCMs and derivatives clearing organizations, and enhancing the oversight of FCMs by their designated self-regulatory organizations).

As the Committee is aware, European,[19] Asian,[20] and other policymakers are currently finalizing or beginning to implement their regulatory reforms with respect to OTC derivatives. While MFA expects these regulations to complement the U.S. market reform to a certain extent, the scope is not identical to the U.S. regulations and they are proceeding at different paces. Therefore, we are concerned that, without sufficient coordination and harmonization as to timing and scope of these different initiatives, conflicting rules will impair market participants' ability to manage their portfolios and regulatory obligations, and present market participants with opportunities for regulatory arbitrage to the detriment of U.S. markets.

One example of an area that highlights the need for international coordination is the regulatory framework for capital and margin requirements for uncleared derivatives. MFA strongly believes that an internationally uniform set of margin requirements will facilitate orderly collateral management practices and minimize regulatory arbitrage in the uncleared swaps and uncleared security-based swap markets. MFA applauds the formation of the Working Group on Margining Requirements of the Basel Committee of Banking Supervision and the International Organization of Securities Commissions to develop a unified international framework for margining uncleared derivatives. In the absence of such uniformity, market participants, including MFA members, will have to monitor and comply with multiple margin regimes, which would be administratively difficult, costly and burdensome, and may increase the likelihood for errors and instances of non-compliance.

Similarly, STP is a critical aspect of mandatory clearing that requires CCPs to accept or reject trades that dealers submit for clearing as quickly as technologically practicable. STP is important because it provides counterparties with immediate certainty as to whether or not their trade has cleared and whether they will face the CCP as their counterparty rather than each other. The CFTC has exhibited strong leadership and has finalized and implemented STP rules.[21]

---

[19] *See* Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories European Market Infrastructure Regulation (EU) No 648/2012 ("**EMIR**"), available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF; and European Commission Delegated Regulation (EU) No 148/2013 of 19 December supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards on the minimum details of the data to be reported to trade repositories, 2013 O.J. (L 52) (September 27, 2012), available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:FULL:EN:PDF.

[20] *See* Hong Kong Monetary Authority and the Securities and Futures Commission joint "Consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong" (October 2011), available at: http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=11CP6; and Monetary Authority of Singapore "Consultation Paper on Proposed Regulation of OTC Derivatives" (February 2012), available at: http://www.mas.gov.sg/~/media/resource/publications/consult_papers/2012/13%20February%202012%20Proposed%20Regulation%20of%20OTC%20Derivatives.pdf.

[21] *See* CFTC Final Rules on "Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management", 77 Fed. Reg. 21307 (April 9, 2012), available at: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-7477a.pdf, which became effective October 1, 2012.

However, other U.S. and non-U.S. regulators have yet to propose similar rules mandating STP.[22] We believe it is necessary for STP to become an international mandate to ensure: (1) market participants' ability to reduce their global counterparty credit risk without delay; (2) market participants' unrestricted access to the broadest range of executing counterparties; and (3) liquidity and competitive pricing of derivatives transactions.

Lastly, it is important that approval by U.S. and non-U.S. regulators of CCPs organized outside their jurisdiction (*i.e.*, third country CCPs) not become unreasonably difficult to obtain. Because of mandatory requirements for clearing of derivatives, it is important to ensure that market participants have sufficient access to, availability of, and competition among, CCPs organized in U.S. and non-U.S. jurisdictions. Otherwise, there is potential that the derivatives market will become fragmented along jurisdictional lines. Such fragmentation could cause significant harm to the markets by, among other things, impeding competition, impairing portability and eventual interoperability, limiting participant access to clearing and their ability to operate in certain jurisdictions, and ultimately creating artificial barriers across a global marketplace and instrument type.

While MFA recognizes that the regulatory regimes of different countries may need to diverge to a certain extent to reflect local concerns, inconsistent regulations will be costly, burdensome and, in some cases, make it impossible for market participants to comply with both regimes. We are appreciative of the ongoing joint efforts of U.S. and non-U.S. regulators to avoid any disharmony between the regulations, to the extent possible, as well as the imposition of duplicative regulation, and encourage continued efforts in this regard. We urge the Committee to continue its oversight of these issues and encourage regulators to work together.[23]

B. Extraterritorial Application of International Regulations

MFA encourages U.S. and non-U.S. regulators to harmonize the extraterritorial scope and substituted compliance frameworks of their derivatives regulatory regimes. The extraterritorial application of the U.S. and non-U.S. derivatives regulations (particularly EMIR[24]) remains a significant area of focus and concern for MFA. Unfortunately, considerable uncertainty continues to exist with regard to this issue. We appreciate the need to ensure that where a market

[22] The SEC has yet to propose a rule mandating STP. From our discussions with European policymakers and regulators, we expect them to include an STP mandate in either the legislative text of the Markets in Financial Instrument Directives or the EMIR Level 3 guidance. However, we do not know how soon any STP mandate will take effect in Europe.

[23] MFA is not aware of any legal impediments that preclude greater cooperation. Nonetheless, MFA urges the Committee to monitor cooperative efforts and consider legislative action, should such discussions identify legal roadblocks.

[24] *See* the European Securities and Markets Authority ("**ESMA**") final report on "Draft technical standards under the Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, CCPs and Trade Repositories" (September 27, 2012), at 6, available at: http://www.esma.europa.eu/system/files/2012-600_0.pdf (indicating that in the future ESMA will issue separate draft regulatory technical standards on contracts that are considered to have a direct substantial and foreseeable effect in the Union).

participant's activities have a direct and significant effect on a jurisdiction, that market participant is subject to adequate regulation in that jurisdiction. However, because the derivatives market is a global market, market participants and their transactions will be subject to regulation in multiple jurisdictions. Thus, we urge harmonization of these regulations to ensure that the extraterritorial scope of the various international reforms will not be duplicative and that related substituted compliance regimes will give sufficient deference to comparable regulations. We believe it important to ensure that, together, the final regulations will provide certainty to market participants, ensure the continued robustness of the derivatives markets and further the progress of international harmony and consistency.

IV. Oversight of Commodity Pool Operators

A. Re-Focusing CPO Registration

MFA believes that Congress should consider enacting amendments to the CEA that would better focus regulatory attention on the entities that are meaningfully engaged in trading commodity interests. Some of the CFTC's recent actions have caused market participants that seek to comply fully with CFTC rules to consider registering many entities that only peripherally are related to CPO activities or technically fall within the relevant legal definitions. MFA believes that it would be a better use of regulatory resources to focus on registration and oversight of CPOs that are operators of entities that are "engaged primarily" [25] in or formed "for the purpose of trading commodity interests."[26]

While we have the utmost respect for the CFTC and its Staff, we believe the CFTC's repeal of Regulation 4.13(a)(4), the CPO registration exemption for a CPO of a private pool, overly broadened the registration mandate for CPOs of private vehicles. As a result, a wide variety of business models, which do not fit or match the CPO regulatory framework, now fall within CPO registration obligations; and the CFTC and National Futures Association ("**NFA**") have and continue to spend substantial resources addressing regulatory issues with respect to entities whose business models do not fit the commodity pool regulatory framework, that are subject to different regulatory regimes, engage in minimal trading of commodity interests, or have indirect exposure to commodity interests.

The combination of Dodd-Frank Act changes to the definition of commodity pool and CPO to include swaps transactions,[27] the CFTC's repeal of Regulation 4.13(a)(4)[28] and CFTC staff interpretations[29] greatly expanded the number and types of entities that fall within the meaning of commodity pool. These entities include SEC-registered investment advisers, securitization vehicles, real estate investment trusts, private equity firms, fund-of-funds, family

[25] *See* Section 4m(3)(B) of the CEA.

[26] *See* Sections 1a(10) and (11) of the CEA (defining "commodity pool" and "commodity pool operator").

[27] *See id.*

[28] 77 Fed. Reg. 11252 (Feb. 24, 2012).

[29] *See id.* (interpreting a collective vehicle with even a single swap to be a commodity pool, as well as a fund-of-funds that invests in a fund with commodity interest exposure).

offices, foreign pool operators and business development companies. The CFTC's repeal of Regulation 4.13(a)(4) generated a substantial number of requests for interpretive and compliance relief as investment managers and other entities struggled to rationalize and adapt to different, overlapping regulatory regimes. MFA, in an effort to streamline federal regulation of investment managers, submitted numerous requests to the CFTC for clarifications, no-action or interpretive relief, petition for rulemaking, and guidance.[30] Many of our requests are outstanding; and we continue to work on new requests for regulatory relief.

The CFTC's Regulation 4.13(a)(3) provides an exemption from CPO registration for a CPO of a private pool that has very limited exposure, including from *bona fide* hedging, to commodity interests.[31] In calculating commodity interest exposure, the CFTC staff is of the view that an entity must calculate indirect commodity interest exposure even if the vehicle itself does not trade commodity interests. As a consequence, many fund-of-funds and private investment funds that do not trade commodity interests are swept into the definition of commodity pool. The limited availability of an exemption from registration has created CFTC regulatory obligations for many SEC-registered investment advisers and other types of entities with minimal commodity interest trading or indirect commodity interest exposure.

We believe the CEA does contemplate a broader exemption from CPO registration. The CEA provides that "[t]he term 'commodity pool' means any investment trust, syndicate, or similar form of enterprise ***operated for the purpose of trading in commodity interests***," (***emphasis added***).[32] Also, Section 4m(3) of the CEA introduces the concept of "engaged primarily" with respect to CTA registration, and excepts a CTA that is:

---

[30] *See, e.g.,* letter from MFA, Alternative Investment Management Association, and Investment Adviser Association ("**IAA**"), to David A. Stawick, Secretary, CFTC, dated April 30, 2012, on "Request for an Extension of Time for Compliance with Registration as a Result of the Amendments to § 4.13"; letter from Stuart J. Kaswell, Executive Vice President & Managing Director, MFA, to Gary Barnett, Director, CFTC, dated August, 27, 2012, on "Request for Interpretive Guidance – Transition Period under § 4.13(a)(3)"; letter from Stuart J. Kaswell, Executive Vice President & Managing Director, MFA, to David Stawick, Secretary, CFTC, dated August 30, 2012, on "Petition for Rulemaking to Amend CFTC Rule 4.10(d)(1) & Request for Interim Relief"; letter from MFA and IAA to Sauntia S. Warfield, Assistant Secretary, CFTC, dated November 9, 2012, on "Request for Delayed Compliance Date of Amended Part 4; Former Appendix A of the CFTC's Part 4 Regulations, 17 CFR Part 4"; and letter from MFA, IAA, Asset Management Group of the Securities Industry and Financial Markets Association ("**SIFMA AMG**"), and the Investment Company Institute ("**ICI**"), to Gary Barnett, Director, CFTC, dated November 30, 2012, on "Request for a Temporary Exclusion of an Investment in a Securitization Vehicle as a "Commodity Interest" for Purposes of CPO and CTA Registration and Compliance"; letter from Stuart J. Kaswell, Executive Vice President & Managing Director, MFA, to Sauntia S. Warfield, Secretary, CFTC, dated December 19, 2012, on "Proposed Guidance with respect to § 4.13(a)(3)"; and letter from MFA, IAA, ICI and SIFMA AMG, to Gary Barnett, Director, CFTC, dated January 25, 2013, on "Compliance with Registration Requirements Under Amended Regulations 4.5 and 4.13(a)(3)." *See also note* 39. In addition, MFA has made several informal submissions to the CFTC staff with respect to questions for the CFTC's FAQs on CPO and CTA compliance obligations, and questions regarding Forms CPO-PQR and CTA-PR (still pending with CFTC staff). These letters are available on MFA's website: www.managedfunds.org.

[31] *See* CFTC Regulation 4.13(a)(3).

[32] Section 1a(10) of the CEA.

> registered with the Securities and Exchange Commission as an investment adviser whose business does not consist ***primarily of acting*** as a commodity trading advisor, as defined in section 1a, and that does not act as a commodity trading advisor to any commodity pool that is ***engaged primarily*** in trading commodity interests (***emphasis added***).

Section 4m(3)(B) of the CEA provides that:

> a commodity trading advisor or a commodity pool shall be considered to be "engaged primarily" in the business of being a commodity trading advisor or commodity pool if it is or holds itself out to the public as being engaged primarily, or proposes to engage primarily, in the business of advising on commodity interests or investing, reinvesting, owning, holding, or trading in commodity interests, respectively.

Given that regulatory resources are limited, we believe Congress should direct the CFTC to focus registration oversight of CPOs on entities that are engaged primarily or operated for the purpose of trading commodity interests rather than overseeing entities with minimal or indirect exposure to commodity interests. Accordingly, we recommend that Congress consider amending the CEA by providing a registration exemption for operators of entities that are not engaged primarily in trading commodity interests or formed for the purpose of trading commodity interests.

B. CFTC-SEC Coordination on Regulation Pertaining to Private Fund Operators/Advisors

As a majority of the new CPO registrants are registered investment advisers of private funds, we believe Congress should direct the CFTC and SEC to streamline regulations for operators of private funds and to ensure consistency among regulations. We are concerned that the differences between the CFTC's and the SEC's regulatory frameworks for operators/advisers of private funds creates significant burden on the private fund industry. For example, we are concerned that a private fund manager registered as an investment adviser, CPO and CTA faces three different systemic risk reporting obligations—filing Form PF with the SEC, filing Form CPO-PQR and CTA-PR with the CFTC, and filing quarterly PQR and PR reports with NFA. The overlapping but distinct reporting requirements are a substantial burden on the fund industry.[33] We believe the regulation of private fund managers between the CFTC and SEC should be consistent where there is overlap. Accordingly, we recommend that Congress direct the CFTC and the SEC to collaborate in ensuring that their private fund regulations are consistent.

---

[33] We note that the CFTC worked with the SEC and other regulators in formulating the systemic risk forms. However, the end-product has been different forms requesting for similar information in different ways.

C. Conforming Amendments with respect to Private Pools and the Rescission of the Prohibition on General Solicitation and Advertising

MFA believes that amendments to the CEA are needed to provide for consistent regulation of private pools and investment funds. The Jumpstart Our Business Startups Act of 2012 ("**JOBS Act**") directed the SEC to amend the securities regulations to eliminate the prohibition on general solicitation and advertising with respect to private offerings under Regulation D.[34] Privately-offered investment funds and commodity pools are also subject to Regulation D. The CFTC adopted regulations concerning privately-offered commodity pools to be consistent with the securities regulations, and included provisions prohibiting "public marketing".[35] The CFTC regulations concerning CPOs of privately-offered commodity pools are now inconsistent with the JOBS Act. We believe this situation creates an unreasonable dichotomy between the regulation of advisers of private funds and CPOs of privately-offered commodity pools. Accordingly, we recommend that the Committee amend the CEA to direct the CFTC to ensure that regulations concerning CPOs of privately-offered commodity pools are consistent with the JOBS Act and the relevant securities regulations.[36]

V. Position Limits

MFA urges the Committee to oversee carefully any new CFTC efforts to impose position limits. MFA continues to have significant reservations about the efficacy of position limits; nonetheless we have sought to work constructively with the CFTC on its efforts to implement them. Accordingly, we believe that the CFTC, in promulgating position limit rules, should regulate based on quantitative findings, including the size and depth of markets. We are concerned that inappropriate limits could reduce hedging activity, decrease market liquidity, and artificially raise commodity prices. Most importantly, we believe that persons with independently controlled accounts should be able to treat such accounts separately and not aggregate the positions of such accounts for position limit purposes. We respectfully urge the Committee to encourage the CFTC to take a data-driven approach in setting position limits if it finds that limits are appropriate.

****

[34] Section 201 of the JOBS Act, P.L. 112-106. Section 201 provides that "the prohibition against general solicitation or general advertising . . . shall not apply to offers and sales of securities made pursuant to section 230.506, provided that all purchasers are accredited investors."

[35] *See e.g.,* 68 Fed. Reg. 47221 (Aug. 8, 2003) (Adopting Release for Regulation 4.13(a)(3)), available at: http://www.gpo.gov/fdsys/pkg/FR-2003-08-08/pdf/03-20094.pdf; and 57 Fed. Reg. 34853 (Aug. 7, 1992) (Adopting Release for Regulation 4.7).

[36] *See* letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, MFA, to David A. Stawick, Secretary, CFTC, dated July 17, 2012, on "Harmonization of Compliance Obligations and the Jumpstart Our Business Startups Act and CFTC Regulations" *available at:* https://www.managedfunds.org/wp-content/uploads/2012/07/CFTC-JOBS-Act-final-7-17-12.pdf.

MFA appreciates the opportunity to provide our comments and concerns to the Committee related to reauthorization of the CFTC. We would welcome the opportunity to discuss our comments in greater detail. Please do not hesitate to contact me or Roger Hollingsworth at (202) 730-2600 with any questions you, the Committee, or your staffs might have regarding this letter.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and Chief Executive Officer

Michigan Municipal Electric Association
809 Centennial Way • Lansing, Michigan • 48917-9277
Phone: (517) 323-8346 • Fax (517) 323-8373 • www.mmeanet.org

May 7, 2013

The Honorable Debbie Stabenow, Chair
Committee on Agr., Nutrition & Forestry
United States Senate
328A Russell Senate Office Building
Washington, DC 20510

The Honorable Thad Cochran, Ranking Member
Committee on Agriculture, Nutrition & Forestry
United States Senate
328A Russell Senate Office Building
Washington, DC 20510

Dear Chair Stabenow and Ranking Member Cochran:

Thank you for the opportunity to provide comments as the Senate Agriculture Committee begins considering reauthorization of the Commodities Exchange Act.

The Michigan Municipal Electric Association (MMEA) is the trade group for 41 municipally-owned, public power utilities in the state of Michigan. Over the past three years, MMEA has worked closely with the Commodity Futures Trading Commission (CFTC) to inform the new derivatives regime put in place by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). With the rules largely finalized, MMEA has begun compliance efforts.

We write to bring to your attention, and request relief from, an unintended consequence of the Act that hampers our risk management efforts and those of other municipally-owned utilities. Namely, the swap dealer definition finalized by the CFTC last April has substantially hindered government-owned utilities' ability to hedge against operational risks.

MMEA Hedges to Mitigate Commercial Risk

Public power utilities are sophisticated market participants that engage in swaps activity to hedge legitimate commercial risks. Municipal utilities like MMEA depend on nonfinancial commodity transactions, trade options, and "swaps," as well as the futures markets, to hedge commercial risks that arise from their utility facilities, operations, and public service obligations. Nonfinancial commodity markets play a central role in our ability to secure electric energy, fuel for generation, and natural gas supplies for delivery to consumers at reasonable and stable prices.

In hedging, mitigating or managing operational risks, we are engaged in commercial risk management activities that are no different from the operations-related hedging of an investor-owned utility or an electric cooperative located in the same geographic region.

Non-financial Firms Are Necessary Counterparties

Electric energy is unique among commodities because it cannot be stored; it must be used at the time it is produced. Each regional geographic market has a somewhat different set of demands (driven by weather and other factors) and a different group of financial and nonfinancial counterparties available to meet these demands by entering into utility operations-related swaps needed for hedging price and supply risks.

Owners of electrical generation and distribution facilities – whether investor-owned utilities, municipal or cooperative utilities, or merchant generation companies – operate in their geographical proximity. As they balance their generation to meet changing demands on an hour-to-hour basis, their most likely trading counterparties are other regional market participants. These regional market participants, unlike financial entities, have a vested interest in maintaining the reliability of the electric grid and ensuring that sufficient liquidity exists to manage their operations.

Because there are a limited number of counterparties for any particular operations-related swap, having a variety of counterparties brings important market liquidity and diversity.

The Special Entity "Sub-Threshold" Threatens to Subject End Users to Increased Regulation

Dodd-Frank directed the CFTC to require swap dealers and major swap participants to register and meet strict capital, margin, and reporting and recordkeeping requirements, as well as comply with rigorous business conduct and documentation standards. Congress was concerned that there be a distinction between these market-making entities and end-users that use swaps to hedge commercial risk.

To address those concerns, the Dodd-Frank Act included a "*de minimis* exception" to the definition of a swap dealer, to ensure that the definition captured only those entities engaged in a significant amount of dealing activity. In the proposed rule to define these entities, the CFTC set two separate *de minimis* thresholds relating to the dollar quantity of swaps: $100 million annually for an entity's total swap-dealing activity and $25 million annually for an entity's swap-dealing activity with special entities, which include government owned utilities.

The Not-For-Profit Electric End User Group (NFP EEU) filed comments recommending that the CFTC substantially increase both thresholds. Nevertheless, the final rule greatly increased the overall *de minimis* threshold from the proposed rule, raising it from $100 million to $3 billion, while leaving unchanged the $25 million sub-threshold for swap-dealing activities with special entities.

As a result, nonfinancial entities (such as natural gas producers, independent generators, and investor-owned utility companies) that do not want to be swap dealers, and would otherwise not be captured by the definition, have decided to stop engaging in transactions with government-owned utilities to avoid exceeding the $25 million threshold.

Efforts to Obtain Regulatory Relief Have Been Exhausted

On July 12, 2012, the American Public Power Association (APPA), the Large Public Power Council (LPPC), the American Public Gas Association (APGA), the Transmission Access Policy Study Group (TAPS), and the Bonneville Power Administration (BPA) filed a petition requesting that the CFTC amend its swap-dealer rule to exclude utility operations-related swap transactions from counting towards the special entity threshold.

Instead, the CFTC released a "no-action" letter allowing a counterparty to deal in up to $800 million in swaps with government-owned utilities without being required to register as a swap dealer. The no-action letter, however, also included a number of additional limitations.

The no-action letter has failed to provide nonfinancial counterparties with the assurances they need to enter into swap transactions with municipal utilities. Our traditional counterparties are unwilling to spend the time and money to create a separate compliance process, and adjust their policies and procedures, to facilitate transactions with the small segment of any particular regional market that utility special entities represent.

Several CFTC commissioners have indicated that they believe that relief is appropriate and, absent action by the CFTC, legislation to address this issue directly would be appropriate.

<u>The Public Power Risk Management Act is a Targeted, Technical Correction</u>

On March 11, 2013, Rep. Doug LaMalfa introduced the "*Public Power Risk Management Act of 2013*" (H.R. 1038). The legislation largely mirrors the intent and effect of the NFP EEU petition, providing narrowly targeted relief for operations-related swaps for government-owned utilities. Specifically, the legislation would provide that the CFTC, in making a determination to exempt a swap dealer under the *de minimis* exception, shall treat a utility operations-related swap with a utility special entity the same as a utility operations-related swaps with any entity that is not a special entity.

The legislation carefully defines which entities would qualify as a "utility special entity." It also specifically defines the types of swaps that could and could not be considered a "utility operations-related swap." For example, the legislation specifically prohibits interest, credit, equity, and currency swaps from being considered as a utility operations-related swap. Likewise, except in relation to their use as a fuel, commodity swaps in metal, agricultural, crude oil, or gasoline would not qualify either. Finally, the legislation also confirms that utility operations-related swaps are fully subject to swap reporting requirements.

When implemented, this legislation should provide certainty to nonfinancial entities that they can enter into swap transactions with government-owned utilities without fear of being deemed a swap dealer.

<u>We strongly request that you support inclusion of this legislation as part of a CFTC reauthorization.</u>

Regards,

Jim Weeks

Executive Director

NATIONAL ASSOCIATION OF
Manufacturers

Carolyn Lee
Senior Director, Tax Policy

April 26, 2013

The Honorable Debbie Stabenow
U.S. Senate Committee on Agriculture,
Nutrition and Forestry
Chairwoman
328-A Russell Senate Office Building
Washington, DC 20510

The Honorable Thad Cochran
U.S. Senate Committee on Agriculture,
Nutrition and Forestry
Ranking Member
328-A Russell Senate Office Building
Washington, DC 20510

Dear Chairwoman Stabenow and Ranking Member Cochran:

On behalf of the National Association of Manufacturers (NAM) – the nation's largest industrial trade association – thank you for requesting NAM's input on the Committee's consideration of the reauthorization of the Commodity Futures Trading Commission (CFTC) and the Commodity Exchange Act (CEA). As outlined in more detail below, we are concerned about pending regulations on derivatives that could have a significant negative impact on manufacturers. As the Committee considers the CFTC/CEA reauthorization, we strongly urge you to address outstanding issues surrounding margin and inter-affiliate trades.

Manufacturers use derivatives to manage and mitigate against fluctuations in currency and interest rate valuations and commodity prices and not for speculative trading. The NAM is a steering committee member of the Coalition for Derivatives End-Users, which coordinated the efforts of the end-user community to ensure that the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L.111-203) (Dodd-Frank) did not impede end-users' use of over-the-counter derivatives.

As we have stated on many occasions, imposing unnecessary regulation on end-users, like manufacturers, would limit our ability to use these important risk management tools, increase costs and reduce investment, U.S. competitiveness and job growth. In fact, although end-users' trades only comprise about nine percent of the total over-the-counter derivatives market, end-users provide approximately 94 percent of private sector jobs and regulations that negatively impact these entities will have a broad impact on the economy. Consequently, NAM continues to work to ensure that, as Dodd-Frank is implemented, end-users do not face undue burdens.

Over the past few years, the NAM has worked along with the Coalition to seek enactment of legislation that would clarify the sections in Title VII of Dodd Frank on interaffiliate trades and margin requirements that, if left as currently written, will have a significant negative impact on end-users. These two issues are addressed in legislation currently pending in the U.S. House.

H.R. 634 would ensure that regulators do not impose margin requirements on non-financial end-users, like manufacturers. Specifically, the legislation would clarify the stated intent of the authors of Dodd-Frank that "margin and capital requirements are not to be imposed on end users," and "rules may not be set in a way that requires the imposition of margin requirements on the end user side of a lawful transaction."[1]

Despite the clear Congressional intent on this issue, Prudential Banking Regulators "believe that the statute does require us to impose some type of margin requirement"[2] and have proposed regulation to do so. While the CFTC has proposed a regulation on margin that is preferable to the Prudential Regulators' proposal, even the CFTC regulation does not provide the certainty and assurance to end-users that the enactment of H.R. 634 would offer.

In recent comments, Federal Reserve System Chairman Ben Bernanke acknowledged that Dodd-Frank is complicated and could be improved.[3] Manufacturers believe that H.R. 634 represents the best way to provide much-needed clarity to regulators and certainty to end-users. This bill has long garnered strong support and in fact, in the 112th Congress, similar legislation passed the House by a vote of 370-24.

A second priority for end-users is also addressed in a pending House bill, H.R. 677, which would prevent internal, inter-affiliate trades from being subject to the same regulatory burdens designed for external, market-facing trades. In addition, the legislation, as introduced in the 113th Congress, would ensure that companies that utilize a centralized treasury unit (CTU) to consolidate trading operations through a single affiliated entity can also take advantage of the end-user clearing exemption.[4]

The legislation regarding inter-affiliate trades is necessary to assure end-users that they can continue to employ best practices like utilization of a centralized treasury unit to manage internal and external trading to mitigate risk within a corporate entity. The simple fact is that purely internal, inter-affiliate trades do not increase systemic risk and should be exempt from clearing, margin and certain reporting requirements that were designed to be applied to certain types of external, market-facing trades. This position is supported by the recently released

[1] Volume 156 Congressional Record p. S6192. Reprinting a June 30, 2010 letter from Senator Christopher Dodd and Blanche Lincoln to House Chairmen Collin Peterson and Barney Frank regarding treatment of end users in the Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173.

[2] U.S. Senate Committee on Banking, Housing & Urban Affairs Hearing: *The Semiannual Monetary Policy Report to the Congress.* July 17, 2012

[3] U.S. Senate Committee on Banking, Housing & Urban Affairs Hearing: *The Semiannual Monetary Policy Report to the Congress.* February 26,2013. "Dodd-Frank is a very big, complicated piece of legislation that addresses many different issues. And I'm sure there are many aspects of it that could be improved in one way or another." He went on to cite "(i)n terms of specifics… clarity on what Congress would like us to do about end users, for example."

[4] Section 723 of Dodd-Frank makes the end-user clearing exemption available only to centralized hedging units that "act [ ] on behalf of the [affiliate] and as an agent." However, many manufacturers who have tens or hundreds of affiliates – all of whom consolidate their balance sheets – utilize a centralized treasury structure but these CTUs act as the "principal" in the transaction, not as an agent. The difference, although seemingly nuanced in the statute is enormous in practice. Many corporations have their CTUs act as principals so they can consolidate their relationships with counterparties and cover the entire corporate entity, eliminating the need for every affiliate to have their own set of relationships with counterparties. These centers also allow a company with numerous affiliates to net-down the volume of trades so that they have fewer trades facing the market, engage in trading with fewer partners and have better oversight of those trades. Many companies also have structured their operations to use a centralized treasury center in order to take advantage of the efficiency and centralization of expertise and this model is considered an industry "best practice".

CFTC final rule on "Clearing Exemption for Swaps Between Certain Affiliated Entities" which allows non-financial entities to elect the end-user exemption to avoid having to clear their inter-affiliate trades. However, the final rule does not address the challenges facing companies that utilize a CTU model, making the passage of the legislation all the more necessary and as with margin, only the passage of this legislation would provide the certainty and assurance end-users seek.

Almost three years after the enactment of Dodd-Frank, implementation of the Act is well underway and deadlines for compliance with various regulations are looming. End-users remain extremely concerned about final regulations on margin that could be released shortly and that the CFTC has not acted on the CTU issue. While we remain hopeful that Congress will act shortly on legislation addressing the margin and inter-affiliate issues, in the meantime we urge the Committee to review these issues in the context of the CFTC and CEA reauthorizations.

Manufacturers look forward to working with you and your staff to address these important issues. Thank you in advance for your consideration of our concerns.

Sincerely,

Carolyn Lee

National Cattlemen's Beef Association

May 1, 2013

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

The Honorable Thad Cochran
Ranking Member
United State Senate Committee
on Agriculture, Nutrition and Forestry
328 A Russell Senate Office Building
Washington, DC 20510

Dear Chairwoman Stabenow and Ranking Member Cochran:

Thank you for this opportunity to provide feedback on issues which we would like to see addressed as you work to amend the Commodity Exchange Act (CEA) in conjunction with reauthorizing the Commodity Futures Trading Commission (CFTC). As the oldest and largest national association for the largest segment of American agriculture, the National Cattlemen's Beef Association (NCBA) represents all segments of the beef supply chain. Most every segment of the U.S. beef industry uses commodity futures as a risk management tool. Over the past several years, however, failures within the futures industry have shaken the confidence of its users. We strongly believe these issues should be addressed and that more protection should be given to account holders. The reauthorization of the CFTC is a great opportunity to address these concerns.

As you begin your work on the reauthorization, we would like you to consider two things:

1. Actions by the CFTC always have an impact on the users of futures products. In the proposed rule "Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations" (RIN 3038-AD88), better known as the customer protection rule, we do not believe that CFTC truly considered the cost of the proposed rule versus the benefits it would bring. The CFTC reauthorization should require a full analysis of the costs and benefits of each rule the Commission proposes.

2. Our industry was caught off guard as the original comment deadline for the proposed customer protection rule neared. This is an example of the CFTC not fully engaging the stakeholders that are impacted by their actions. We ask that you consider provisions that would require the CFTC to engage industry groups, trade associations, and other stakeholders when considering proposed rules or actions.

We look forward to working with you on the CFTC reauthorization. Please contact Colin Woodall in our Washington, D.C., office if you have any questions or need additional feedback. He can be contacted at (202) 879-9123 or cwoodall@beef.org

Again, thank you for this opportunity and for considering our requests.

Sincerely,

Scott George

Scott George
President

NCFC
National Council of Farmer Cooperatives

Tel: 202-626-8700
Fax: 202-626-8722
50 F Street, NW Suite 900
Washington, DC 20001
www.ncfc.org

May 1, 2013

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

The Honorable Thad Cochran
Ranking Member
Senate Committee on Agriculture
328A Russell Senate Building
Washington, DC 20510

Dear Chairwoman Stabenow and Ranking Member Cochran:

On behalf of the more than two million farmers and ranchers who belong to farmer cooperatives, the National Council of Farmer Cooperatives (NCFC) appreciates this opportunity to provide input to the Committee as you prepare to review the Commodity Exchange Act (CEA) and reauthorize the Commodity Futures Trading Commission's (CFTC) oversight of the futures and swaps markets.

Since 1929, NCFC has been the voice of America's farmer cooperatives. Our members are regional and national farmer cooperatives, which are composed of over 2,500 local farmer cooperatives across the country. As processors and handlers of commodities, farmer cooperatives – and their farmer-owners – rely on futures and swaps markets to hedge the commercial risk inherent to agricultural production, processing and marketing. In addition, there are cooperatively-owned futures commission merchant (FCM) operations that are relatively small and serve a customer base comprised of physical commodity hedgers.

By providing price risk management tools to their farmer-owners, farmer cooperatives help mitigate commercial risk in the production, processing and selling of a broad range of agricultural and food products. America's farmers, ranchers, and their cooperatives must continue to have access to risk management products that enable them to feed, clothe and provide fuel to consumers here at home and around the world.

The Dodd-Frank Act

We greatly appreciate the ongoing oversight the Committee has provided as the Dodd-Frank rules have been written. Your work in encouraging the CFTC to ensure that the agriculture industry has affordable access to innovative risk management tools once the Act is implemented is commendable. With your continued leadership, we are hopeful that the agriculture industry will avoid being subject to a "one-size-fits-all" type of regulation intended for Wall Street.

NCFC supports elements of the Dodd-Frank Act that bring more transparency and oversight to the OTC derivatives markets. We also recognize the complexity in crafting rules for the implementation of Dodd-Frank that best fit cooperatives. With the sheer volume of rules, the challenges in clearly understanding what is contained in those regulations, and the complexity of how they will fit together, NCFC members have been turning their attention to compliance. Our members are doing their best to put into place policies and procedures, but they are finding it a challenge to understand what exactly needs to be done to address the complex regulations. Our members also have concerns regarding how CFTC will enforce the regulations. Because the regulations are very complex, we urge the committee to encourage CFTC to work closely with industry to ensure clear understanding by all parties before beginning any enforcement actions.

There are still many unknowns as to how implementation of the rules will affect cooperatives and their farmer members as uncertainty over ultimate costs and market liquidity remain ongoing concerns. Agriculture is a high-volume, low-margin industry, and incremental increases in costs, whether passed on from a swap dealer or imposed directly on a cooperative, will trickle down and impact producers. Taken one rule at a time, the costs may not seem unreasonable, but to those who have to absorb or pass on the collective costs of numerous regulations, it is clearly evident those costs are significant.

It is also unclear how other costs will be forced down to end users and impact their ability to hedge. As commercial end users, cooperatives often use swap dealers in utilizing the OTC market to lay off the risk of offering forward contracts to producers and customers. However, the costs associated with dealers' compliance with capital, margin and other regulatory requirements are still unclear. It remains to be seen how those costs will be passed on to end users, and how cost effective the OTC market will remain for future hedging activities.

Customer Protection

NCFC supports strengthening protections for futures customers and appreciates the Committee's hearings and the work CFTC has done in proposing new rules in this area subsequent to the failure of MF Global and Peregrine to protect customer funds. However, we are concerned with the potential unintended consequences that a "one-size-fits-all" regulation may have on hedgers and smaller FCMs. The proposed rules do not take into account the type of FCM – by size, the risk profile of their customers, or whether or not the FCM also has proprietary trading or is a broker-dealer. In addition to increased costs for hedgers, this proposed rule would be more burdensome to smaller firms like farmer cooperative-owned FCMs, which largely deal only with hedgers. Regulations that would accelerate a further consolidation in the FCM industry would have the adverse effect of leaving commodity hedgers with fewer options, while concentrating risk among fewer FCM entities. While the issues behind the decreasing numbers of FCM's are more complex than just regulatory burden, we are concerned with unintended consequences of several aspects of the proposed regulations, including changes around capital charges, residual interest, and establishment of risk management systems.[1]

---

[1] A recent report by the TABB Group predicted that the number of FCMs would fall below 100 by the end of 2013, down from 154 in 2007. The report estimates that the top three FCM's account for 30-40% of total revenues and

Thank you again for the opportunity to provide input ahead of the Committee's work in this area. We look forward to working with you throughout the process, and appreciate your role in ensuring that farmers and their cooperatives continue to have the ability effectively hedge commercial risk and support the viability of their farms and cooperatively owned facilities.

Sincerely,

Charles F. Conner
President & CEO
National Council of Farmer Cooperatives

---

the top 10 account for around 75% of total revenues (a news article can be found at: http://www.thetradenews.com/news/Regions/Americas/US_FCMs_to_reduce_by_a_third_in_six_years_by_enc 2013_%E2%80%93_TABB.aspx).

National Farmers Union
UNITED TO GROW FAMILY AGRICULTURE

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

Dear Chairwoman Stabenow and Ranking Member Cochran:

Thank you for the opportunity to offer comments on the reauthorization of the Commodity Futures Trading Commission (CFTC). National Farmers Union (NFU) members understand the great importance of this regulatory agency and we are encouraged by the work of the Senate Agriculture Committee in preserving the integrity and effectiveness of the CFTC.

Farmers Union members rely upon functioning commodity markets in order to sell their crops or livestock as well as to purchase inputs. These markets have wide-ranging impacts upon the rural and agricultural economies. For example, high commodity prices can result in elevated land prices, making entry into agriculture cost prohibitive for new and beginning farmers. Low commodity prices can send crop farmers into dire financial straits but may improve the standing of dairy farmers, ranchers, and poultry growers. Because of the reverberations that result from volatility in the commodity markets, diligent market oversight by the CFTC is necessary to long term success for family farmers and ranchers.

NFU opposed the deregulation of much of the financial sector in the 1990s and supported the landmark Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). The Dodd-Frank Act made vital regulatory improvements to help prevent the abuse of commodity markets. NFU is a member of the Commodity Markets Oversight Coalition, a group comprised of organizations representing *bona fide* hedgers and commercial end-users in a variety of economic sectors. CMOC has also submitted comments on the CFTC reauthorization, which further detail many specific concerns that the committee should address.

At the time of their creation, commodity markets were designed to serve as a tool for commercial end-users and hedgers to mitigate price and uncertainty risks faced in their enterprises. The commodity markets were – and still should be – used to establish fair prices according to supply and demand fundamentals. Unfortunately, massive positions held by speculators and a culture of deregulation has distorted these markets. Although speculation is

National Farmers Union

UNITED TO GROW FAMILY AGRICULTURE

necessary to provide markets with liquidity and to assist in risk management practices, speculation has come to dominate commodity markets. A study by CFTC found that as much as 80 percent of market activity is conducted by speculators and that speculative activity has increased by at least 64 percent since June 2008. This level of activity certainly qualifies as "excessive speculation."

The CFTC has taken action on mandatory position limits in accordance with Section 737 of the Dodd-Frank Act. A final rule was published on Oct. 18, 2011, which NFU supported. However, before the rule could go into effect, it was overturned by a District Court Judge on Sept. 28, 2012. The court's decision is under appeal, and NFU was among a coalition of organizations who submitted an amicus curiae brief with the hope that the ruling will be reversed.

Whether or not the position limits rule is allowed to be implemented, NFU urges the committee to further investigate the position limits rule of Oct. 18, 2011, in order to determine the effectiveness of the rule. The limits may be set too high to have a substantial impact on the market manipulation brought about by excessive speculation. When reauthorizing the CFTC, class-specific limits on speculation ought to be enacted and additional, more stringent position limits in the spirit of the Dodd-Frank Act should be implemented.

There are other crucial regulatory issues to be addressed by CFTC in the coming years and the committee should consider them during the reauthorization process.

- High frequency trading (HFT) is a high risk operating procedure that oftentimes diverges from market fundamentals in determining commodity prices. NFU asks that the committee call for further investigation and regulation of HFT automated activity.
- Index funds are an ever-growing player in commodity markets and are tied to the excessive speculation that increases volatility. Several legislative initiatives are in progress to prohibit index funds from taking positions in commodities. NFU urges the committee to direct CFTC to limit or end index fund commodity speculation in the CFTC reauthorization.
- As the financial stakes continue to rise in the commodity markets, so too should penalty assessments. Speculators should be deterred by fines rather than just considering the penalties as simply the cost of doing business. Higher penalties will more effectively deter illegal and unlawful behavior.

National Farmers Union

UNITED TO GROW FAMILY AGRICULTURE

Farmers are at the core of our rural economy and are helping to drive our nation's recovery from a difficult economic time. Another commodity price bubble or a sudden collapse would be difficult for many farmers to weather. A reauthorized and energized CFTC will help to bring stability to the levels of commodity price volatility that are so damaging to NFU members.

Thank you for your consideration of these comments and I look forward to working with the committee throughout the CFTC reauthorization process.

Sincerely,

Roger Johnson

Roger Johnson

President

NFA NATIONAL FUTURES ASSOCIATION

May 1, 2013

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

The Honorable Thad Cochran
Ranking Republican Member
U.S. Senate Committee on Agriculture, Nutrition, and Forestry
328A Russell Senate Office Building
Washington, DC 20510

Dear Chairwoman Stabenow and Ranking Member Cochran:

Thank you for your March 7th letter requesting NFA's input and recommendations relating to CFTC Reauthorization. Your letter correctly highlights that this year's reauthorization comes at an important, but challenging time as the CFTC continues to implement the Wall Street Reform and Consumer Protection Act and markets are evolving rapidly and face extraordinary regulatory and market pressures. Your letter further states that the failures of MF Global and Peregrine Financial Group ("PFG") raise questions about how better to protect customers, which is critically important and the essence of what we do.

Customer Protection Initiatives

For years, the futures industry had an impeccable reputation for safeguarding customer funds deposited at FCMs. Within a very short time frame, we had a shortfall in customer segregated funds at two FCMs and ensuing bankruptcies. Customers at both firms suffered real harm, the type of harm that all regulators attempt to prevent. These customer losses are a reminder that regulators must continuously improve surveillance, examination and fraud detection techniques to keep pace with changing technology and an ever-more-complicated global financial marketplace. Since the PFG and MF Global cases, we have worked closely with the CFTC and other self-regulatory organizations (SROs) to adopt a number of initiatives to further safeguard customer funds.

NFA

Daily Confirmations from all Segregated Funds Depositories—NFA and the CME Group, along with the IntercontinentalExchange Inc. and Minneapolis Grain Exchange, developed and implemented a system that requires all depositories holding customer segregated funds on behalf of an FCM to directly report balances daily to SROs. The SROs perform an automated comparison to the daily reports filed by the FCMs to identify any suspicious discrepancies. In February 2013, Phase 1, which centered on the confirmation of customer segregated funds held by bank depositories, was completed. In March 2013, NFA and CME Group commenced Phase 2 of the monitoring system which will focus on confirming balances for customer segregated funds held in non-bank depositories, mainly accounts held at clearing FCMs and clearinghouses. Phase 2 is scheduled for completion in late summer 2013.

MF Global Rule—All FCMs are now required to provide regulators with immediate notification if they draw down their excess segregated funds (funds deposited by the firm into customer segregated accounts to guard against customer defaults) by 25% in any given day. Such withdrawals must be approved by the CEO, CFO or a financial principal of the firm and the principal must certify that the firm remains in compliance with segregation requirements. This rule became effective on September 1, 2012.

FCM Transparency—All FCMs must file certain basic financial information about the firm with NFA and that information will be posted on NFA's web site. The information includes data on the FCM's capital requirement, excess capital, segregated funds requirement, excess segregated funds and how the firm invests customer segregated funds. The public display of FCM financial information on NFA's website provides investors with another tool to help them conduct due diligence before choosing an FCM. The investing public is now able to visit NFA's website to obtain general information about an FCM, publicly available disciplinary information and financial information. The display of FCM financial information on NFA's website began in November 2012, and these web pages have received over 15,000 hits.

Review of NFA Examination Procedures—NFA's Special Committee for the Protection of Customer Funds—consisting of all public directors—commissioned an independent review of NFA's examination procedures in light of the PFG fraud. The study was conducted by Berkeley Research Group ("BRG"), and former SEC personnel who conducted that regulator's review of the SEC's practices after the Madoff scandal. BRG's report was completed in January 2013. The report stated that "NFA's audits

NFA

were conducted in a competent manner and the auditors dutifully implemented the appropriate modules that were required". The report, however, also included a number of recommendations designed to improve the operations of NFA's regulatory examinations in the areas of hiring, training, supervision, examination process, risk management, and continuing education. NFA has already taken a number of steps to implement BRG's recommendations. A Special Committee appointed by NFA's Board will oversee the timely implementation of these recommendations.

Internal Controls Guidance—NFA, CME Group and other SROs developed more specific and stringent standards for the internal controls that FCMs must follow to monitor their own compliance with regulatory requirements. NFA has drafted an interpretive notice that contains specific guidance and identifies the minimum required standards for internal controls in a number of areas such as separation of duties; the firm's procedures for complying with customer segregated and secured amount funds requirements; establishing and complying with appropriate risk management and trading practices; restrictions on access to communication and information systems; and monitoring for capital compliance. NFA will submit the interpretive notice to the CFTC shortly for its review and approval.

<u>Study Regarding Customer Account Insurance</u>

In light of the failures of MF Global and PFG, there have been growing calls for some form of customer account insurance. This issue has not been analyzed in detail since NFA performed an insurance study in 1985. Therefore, FIA, the Institute for Financial Markets, the CME Group and NFA have undertaken an industry-funded customer account insurance study. The study will not include recommendations for or against any form of insurance but will analyze and estimate the potential costs and assess the potential benefits of several possible forms of a customer account insurance program. The study is scheduled for completion in late spring/early summer.

<u>FCM Bankruptcy Reform</u>

Both the PFG and MF Global bankruptcies highlighted the need for greater customer protections to not only guard against the loss of customer funds but also in the event of an FCM's insolvency. As discussed above, NFA has made and continues to implement changes to enhance the safety of customer segregated funds and guard against a shortfall in customer funds in the event of any future FCM failures.

NFA

The Honorable Debbie Stabenow
The Honorable Thad Cochran

May 1, 2013
Page Four

NFA believes, however, that the CFTC Reauthorization process should be used to pursue a number of possible changes to Bankruptcy Code provisions that govern an FCM's liquidation that would likely strengthen customer protections and priorities in the event of a future FCM bankruptcy. We fully recognize that any changes to the Bankruptcy Code regarding FCM insolvency protections will not be easy to achieve during CFTC Reauthorization due to Congressional Committee jurisdictional issues. Yet we strongly believe that the two recent FCM failures have highlighted the need for enhanced customer protections that can only be achieved via changes to the Bankruptcy Code.

We are in discussions with all facets of the industry to arrive at a consensus view on changes that should be made. Chief among NFA's concerns in this area is removing the uncertainty raised by the court in the Griffin Trading Company bankruptcy so that "customer property" is clearly defined going forward to include an FCM's general estate assets so that in instances where customer assets are insufficient alone to satisfy customer claims, then customers should receive first priority to the FCM's general estate assets until customer claims are paid in full. Other issues may include reviewing whether it is appropriate that all joint FCM/broker-dealer bankruptcies be administered under SIPA.

Detecting and combating fraud is central to our mission. No system of regulation can ever completely eliminate fraud, but we must always strive for that goal. The process of refining and improving regulatory protections is ongoing and the initiatives outlined above do not mark the end of our efforts. We will continue to work with Congress, the CFTC, SROs and the industry to ensure that customers have justified confidence in the integrity of the U.S. futures markets.

I welcome the opportunity to visit with you to discuss any of the material in our response.

Sincerely,

Daniel J. Roth
President

m:\tws\senator stabenow ltr reauthorization 5 1 13

National Grain and Feed Association

1250 Eye St., N.W., Suite 1003, Washington, D.C. 20005-3922, Phone: (202) 289-0873, FAX: (202) 289-5388, Web Site: www.ngfa.org

May 6, 2013

The Honorable Debbie Stabenow
Chairwoman, Committee on
Agriculture, Nutrition & Forestry
U.S. Senate
Washington, D.C. 20510

The Honorable Thad Cochran
Ranking Member, Committee on
Agriculture, Nutrition & Forestry
U.S. Senate
Washington, D.C. 20510

Dear Chairwoman Stabenow and Ranking Member Cochran:

The National Grain and Feed Association (NGFA) is very appreciative of the opportunity to provide input to the committee regarding issues to be considered during reauthorization of the Commodity Futures Trading Commission (CFTC). Our preliminary thoughts and recommendations appear below.

Customer Protection

Companies and individuals that were customers of MF Global Inc.'s futures business continue to deal with the aftermath of parent company MF Global Holdings' bankruptcy and the subsequent liquidation of the futures commission merchant (FCM). Most customers so far have received distributions from the trustee of about 89% of their funds – funds that were supposed to have been segregated and protected. We are hopeful that the remaining 11% of customer funds will be returned to customers, but there is still no assurance of their being made whole. Consequently, we believe that a primary focus of the reauthorization process must continue to be enhancing customer protections with the twin goals of preventing similar occurrences in the future and providing protection to customers in the event of a future FCM insolvency.

Reforms to U.S. Bankruptcy Code – The NGFA believes strongly that reforms to the U.S. bankruptcy code are essential to preserving and codifying customers' rights and protecting customers' assets in the event of future FCM insolvencies. To that end, the NGFA recommends the following statutory changes:

- The bankruptcy code should state clearly that customers always are first in line for distribution of funds, ahead of creditors, and that all proprietary assets including those of affiliates must go to customers first. This would provide clarity to regulators and to the courts in terms of prioritization of claims, an area in which precedent has not been established.

- Part 190 regulations of the CFTC should be incorporated into Subchapter IV of Chapter 7 of the bankruptcy code to harmonize the statutes and remove any interpretative inconsistencies. Generally, the bankruptcy code provides a limited description of the liquidation process of a commodity futures broker. The Commodity Exchange Act and bankruptcy regulations drafted by the CFTC provide much greater and more detailed guidance for the liquidation of a commodity broker or FCM.

- Under current bankruptcy law, powers of a trustee to recover customer funds are limited under so-called "safe harbor" provisions unless actual intent to defraud customers/creditors can be shown. The NGFA strongly recommends that any transaction involving the misappropriation of an FCM's customer property should not be protected under safe harbor provisions, regardless of the intent behind a fund transfer.

- To strengthen commodity customer protection, the CFTC should have a specifically identifiable role in the liquidation of an FCM. The CFTC should have the authority to appoint its own trustee to represent exclusively the interests of commodities customers. In a case like MF Global, in which over 95% of the assets and accounts affected were those of commodities customers, we believe the CFTC's authority should be strengthened and clarified.

- In the MF Global situation, creditor committees were established under the MF Global Holdings Chapter 7 proceeding, but there was no statutory provision under the SIPA liquidation of the MF Global Inc. FCM for establishment of customer committees. The NGFA recommends that the bankruptcy code expressly should authorize the establishment of customer committees to represent FCM customer interests.

We are aware that other organizations also are working toward specific recommendations for changes in the bankruptcy code that will enhance customer protections. The NGFA intends to work cooperatively with such groups to develop consensus reforms that can be moved by Congress expeditiously.

Insurance or Liquidity Protection for Commodity Futures Customers – The NGFA recommends that insurance or insurance-like products should be available to commodity futures customers. Customers and their lenders who finance hedging in commodity markets must have confidence that their funds are safe and protected. We are aware that the Futures Industry Association currently is finalizing a comprehensive analysis of potential products and costs, and we consider it prudent to see that study before recommending a particular structure. We also are aware that the Commodity Customer Coalition recently has completed an online survey of commodity futures customers to gauge interest and input on insurance products. This data also could prove useful in crafting appropriate solutions.

Since the NGFA began working on potential customer protection enhancements early last year, we have been very mindful that most new customer protections will come at a cost – and that, eventually, the cost most likely will be borne by the customer. For that reason, we have taken a deliberate approach to recommending specific new protections, and we respectfully suggest that Congress and all stakeholders adopt a similarly cautious view. On the bright side, since the collapse of MF Global, significant new operational safeguards that should enhance the safety of customer funds have been put in place on commodity accounts. These enhancements, already in place, should help mitigate costs of insurance or other customer protection efforts.

It is important to note that the solution on insurance to protect customers is not necessarily a government solution or a legislated solution. It may be that some form of privately provided product is more cost-effective and more appropriate. The NGFA has taken no formal view at this point on any specific structure. We advise strongly that data from the above-referenced efforts should be carefully considered prior to making such an important decision.

Fully Segregated Customer Accounts/Pilot Program – Currently, the Commodity Exchange Act and U.S. bankruptcy code provide for *pro rata* distribution of all customer property that was held by a failed futures commission merchant (FCM). After eighteen months, former customers of MF Global have received back only 89% of their supposedly safe segregated funds through distributions from the trustee, with no assurance that they ever will receive 100% of their funds. This is unacceptable, including to lenders who finance hedging of customers who use exchange-traded futures and options. Restoring the confidence not only of customers, but also of their lenders, is critically important. To that end, the NGFA has recommended establishment of an *optional* fully-segregated account structure to be offered and utilized by mutual agreement of customers and their FCMs.

Creation of a fully-segregated account structure necessarily would result in some additional costs that likely would be borne by customers that utilize such accounts. It is likely that some customers would opt for the added protections despite extra costs, while other customers might be unwilling or unable to bear those extra costs. For that reason, we propose that the full-segregation option be utilized on a voluntary basis at the agreement of an FCM and its individual customers.

We suggest that a pilot program involving a limited number of commodity futures customers, FCMs, and lenders, along with regulators, would be a useful means of testing the mechanics and identifying the viability and true costs of a full-segregation structure. The NGFA does not recommend legislative action to establish a full-segregation account structure, but support for a pilot to test concepts would be constructive.

High Frequency Trading

Increasingly, traditional customers of agricultural futures markets are concerned about the impacts of high-frequency trading. Especially immediately preceding and following release of important crop and stocks reports by the U.S. Department of Agriculture, we believe high-frequency trading has caused and magnified volatile market swings. These disruptions have led many hedgers who use futures markets to avoid futures markets at such times. Concerns also have been raised about the impact of high-frequency trading on order fills for traditional hedgers.

It may be that regulatory action by the CFTC is the more appropriate way to address high-frequency trading issues. Should high-frequency traders be required to register with the Commission? Should such traders be required to post margin even if no positions are held at day's end? Are there other measures that should be considered to help ensure that high-frequency trading does not disrupt futures markets in ways that render them less useful to hedgers managing business risk? The NGFA suggests that these kinds of questions should be part of the conversation during reauthorization.

CFTC's Customer Protection Proposal

The CFTC currently is evaluating comments submitted with regard to a proposed rule issued November 14, 2012, that seeks to bolster futures customer protections – a laudable goal. However, two very troublesome provisions in the proposed rule would have the effect of dramatically changing the way business has been conducted in futures markets for decades. The NGFA believes the two provisions would have the perverse impacts of significantly ***increasing*** futures customer risk in the event of future FCM failures.

One provision concerns the timing of when an FCM is required to take a capital charge for undermargined accounts. The other would change the manner and timing of FCMs' calculation of residual interest for futures accounts. The NGFA believes that either provision, if contained in a final rule as originally proposed, would have the chilling effect of forcing FCMs to require pre-margining of hedge accounts – and perhaps also intra-day margining. The practical end result would be that futures customers would be required to send much more money to their FCMs in anticipation of market moves that might never happen. Some customers likely would simply exit futures markets in favor of lower-cost risk management alternatives. Clearly, the proposals would put a much greater amount of customer funds at risk when the next FCM fails. If this rule had been in place when MF Global failed, perhaps twice as much customer money would have been missing and a correspondingly larger amount still would not be returned to customers.

Discussions with the Commission have not resolved these issues to date. It is difficult to understand the reason for such a dramatic change in the CFTC's stance after decades of consistent interpretation. However, if the Commission believes its hands are tied due to provisions of the Commodity Exchange Act, Congressional action may be needed to clarify the matter.

We look forward to working with the committee on these and other matters during the reauthorization process. Please do not hesitate to contact the NGFA with any questions.

Sincerely,

Diana Klemme

Diana Klemme, Chair
Risk Management Committee

John M. Heck

John Heck, Chair
Finance & Administration Committee

N.I.B.A.
National Introducing Brokers Association

FAX Cover Sheet

This Fax is 3 pages Including this Cover Sheet

To: Chairwoman Debbie Stabenow
U.S. Senate Committee on Agriculture, Nutrition and Forestry

Ranking Republican Member Thad Cochran
U.S. Senate Committee on Agriculture, Nutrition and Forestry

From: Melinda Schramm, Chairperson
National Introducing Brokers Association (NIBA)
www.theniba.com
melinda@futuresrep.com

RE: CFTC Reauthorization

DATE: July 2, 2013

By FAX

Included with this FAX Cover Sheet is a 2-page comment letter regarding issues surrounding the Reauthorization of the Commodity Futures Trading Commission (CFTC). Please include this information with the other comment letters the Committee has received.

Please contact me at 312.498.3518 or by email at melinda@futuresrep.com for additional information about this submission and to provide documentation or comment at the time of the Committee's hearings.

Thank you,
Melinda Schramm
Melinda Schramm, Chairperson
NIBA

N.I.B.A.

National Introducing Brokers Association

July 1, 2013

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

The Honorable Thad Cochran
Ranking Republican Member
U.S. Senate Committee On Agriculture, Nutrition and Forestry
328A Russell Senate Office Building
Washington, DC 20510

Dear Chairwoman Stabenow and Ranking Member Cochran:

The National Introducing Brokers Association appreciates the opportunity to submit the following comments to the Senate Agriculture Committee (Committee) with regard to issues relating to the reauthorization of the Commodity Futures Trading Commission (CFTC).

The National Introducing Brokers Association (NIBA) is a non-profit membership association of Introducing Brokers (IBs), Commodity Trading Advisors (CTAs) and Associated Persons (APs). Founded in 1991, the NIBA's purpose is to provide education to registrants primarily engaged in futures and options transactions on behalf of retail market users. The Association has the support of Futures Commission Merchants (FCMs) and Exchanges, and has voiced the opinion of its member-brokers in U.S. House Committee hearings and CFTC reauthorization hearings, as well other CFTC meetings and roundtables for over 20 years.

Customer Collateral Protections

The NIBA generally commends both the CFTC and the National Futures Association (NFA) in their efforts to improve surveillance and fraud detection in an increasingly complex global marketplace. The public display of FCM financial information on the NFA's website, and the so-called "MF Global" Rule are appropriate, and easy for customers to access and understand. However, NIBA members are concerned by the CFTC proposal that FCMs maintain a residual amount sufficient to cover the aggregate of customer margin deficits on a continual basis. Members believe that this requirement could substantially decrease liquidity. A decrease in liquidity is sure to cause an increase in costs for FCMs which will ultimately be passed on to end-users through their brokers. NIBA urges the Committee to re-examine this CFTC proposal. (*Also see*, NIBA Comment Letter February, 2013)

NIBA also believes that the Committee should give the CFTC the authority to determine the appropriate liquidation forum in the event of an FCM insolvency. In the MF Global (MFG) situation customers were confused and industry concerns were raised from the outset of the SIPA process because the revenues of MFG were overwhelmingly derived from its FCM business as opposed to its securities firm. In addition, in that context NIBA feels CFTC communications to an unsettled constituency were lacking.

Brokers Concerns

1.35 Recordkeeping Requirements. NIBA members are also concerned by the expansion of current data requirements as it relates to recordkeeping requirements detailed in Part 1 of the CFTC regulations. (*Also see*, NIBA Comment Letter August, 2011)This expansion of the written requirements, as well as the new requirement to record oral conversations, is certain to increase costs of compliance and strain business operations when the rule takes effect later this year. In addition to expense concerns, NIBA members are left trying to understand the scope of the requirement because of the vague language used throughout the new requirement. IBs and many CTAs have been through financial hard-times in the wake of the MF Global and Peregrine Financial defaults. They have struggled to keep their businesses together and to restore customer confidence in the process. This struggle has taken a heavy financial toll on the community as a whole. Although an exemption for smaller businesses has been contemplated by CFTC, NIBA believes this is not enough, and strongly urges the Committee to review Proposed Reg. 1.35.

Customer Account Insurance/ FCM Bankruptcy Reform

The NIBA recognizes the need to further study some form of customer account insurance. We support the efforts currently being undertaken by the Futures Industry Association (FIA), NFA and other industry groups.

NIBA believes that the CFTC Reauthorization process is the right venue to examine possible changes to the Bankruptcy Code which govern an FCM's liquidation. Any uncertainties regarding the definition of "customer property" should be clearly defined to allow claims against the FCM's general estate assets until the customer claims are paid in full. NIBA also believes that brokers' commissions and withholding or guarantee accounts they fund on the FCM's books should not be included among the general creditors of the bankrupt FCM, but should be moved up in the creditors chain because of their special relationship to the bankrupt entity.

Thank you for your careful consideration of all the above matters. Please do not hesitate to contact me at 312.498.3518 or melinda@futuresrep.com, if I can provide additional information on these issues.

Best regards,
Melinda Schramm
Melinda Schramm, Chairman, National Introducing Brokers Association

National Rural Electric
Cooperative Association
A Touchstone Energy® Cooperative

May 1, 2013

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

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

Dear Chairwoman Stabenow and Ranking Member Cochran:

NRECA appreciates the opportunity to respond to the Senate Agriculture Committee's request for input as you consider the reauthorization of the Commodity Futures Trading Commission (CFTC) this year.

NRECA is the national service organization representing over 900 not-for-profit, member-owned, rural electric cooperative systems, which serve 42 million customers in 47 states. NRECA estimates that cooperatives own and maintain 2.5 million miles or 42 percent of the nation's electric distribution lines covering three-quarters of the nation's landmass. Cooperatives serve approximately 18 million businesses, homes, farms, schools and other establishments in 2,500 of the nation's 3,141 counties.

Electric cooperatives are commercial end-users and not financial entities. Through the implementation of *the Wall Street Reform and Consumer Protection Act* ("Dodd-Frank Act"), we have filed comments on approximately 50 rules that could impact our members. We believe that CFTC reauthorization is a process where Congressional oversight helps ensure that the CFTC is implementing the Dodd-Frank Act as Congress intended. To that end, NRECA believes that Congress should ensure that resources at the CFTC are prioritized to protect against systemic risk to our financial system, and not needlessly focused on the legitimate hedges of end-users.

Through CFTC reauthorization, we would like to offer the Committee ideas to protect end-users from being subjected to unnecessary, burdensome and costly regulations. To assist end-users such as electric cooperatives, we suggest the creation of an "end-user ombudsman," or type of independent advocate specifically for end-users within the CFTC. Additionally, we would suggest that the CFTC dedicate a special section of the Commission's website to end-users with information specifically designed for their needs. We believe end-users would benefit from such actions to provide attention to end-user concerns, and more quickly bring those concerns to resolution within the CFTC.

4301 Wilson Blvd. • Arlington, VA 22203-1860 • tel: 703.907.5500 • www.nreca.coop

We look forward to discussing these and other ideas to support end-users as your Committee moves forward with CFTC reauthorization.

Sincerely,

Kirk Johnson
Senior Vice President, Government Relations
National Rural Electric Cooperative Association

NEXTera® ENERGY RESOURCES

Top Legislative Items for CEA Reauthorization

May 16, 2013

New Swap Rules Are Having Significant and Often Unintended Impacts on Energy Companies

Primary Areas of Concern

- Definition of financial entity needs to be changed
- Swap dealer de minimis level should not be permitted to change without affirmative CFTC action
- Special entity de minimis level should not apply to transactions with government-related utilities
- End-user clearing exception should be available to commercial entities with central desks
- Inter-affiliate swaps should not be subject to most regulations
- Bona fide hedging under the position limits should not be overly restrictive
- Commercial firms should not be subject to margin requirements

NEXTera ENERGY RESOURCES

Overly Broad Regulations and Uncertainty Ultimately Will Increase Commodity Prices for All Consumers

Key Consequences

- Commercial energy companies are being subjected to regulations designed for banks and investment funds
- Compliance costs are dramatically increasing due to regulatory uncertainty and affirmative obligations
- More difficult to efficiently hedge business risks

Ultimate Consequence: **Increased costs and inefficient hedging result in higher utility bills for all consumers, which directly impacts the national economy**

NEXTera ENERGY RESOURCES

Financial Entity Definition Should Be Changed - Central Desks of Commercial Entities Should Not Be Regulated Like Financial Entities

Financial Entity Definition Needs to be Amended

- **End-users get special treatment not afforded to financial entities in Dodd-Frank and CFTC rules**
  - Including exception from mandatory clearing of swaps and no mandatory margin for uncleared swaps
- **"Financial entity" definition references activity that is "financial in nature" in banking laws**
  - "Financial in nature" means activity banks can do including some physical commodity transactions common in the power industry
- **Cross-reference to banking laws may cause central hedging and marketing affiliates of commercial energy companies to be regulated like financial entities (e.g. hedge funds and banks)**

***Takeaway*: amend definition of "financial entity"**

NEXTera ENERGY RESOURCES

Swap Dealer De Minimis Level Should Only Change With Affirmative Action by the CFTC

Swap Dealer De Minimis Should Not Drop by Default

- **Swap dealer de minimis amount currently $8 billion, but automatically reduces to $3 billion in 2016 unless CFTC takes action**
- **Reduction is a significant change in market structure that should require a formal rulemaking**
- **Threat of regulator inaction is potentially very disruptive to market confidence**
- **Rule is forcing businesses to curb certain activities *now* because the level *may* drop**
  - Swap dealer definition is overly broad, ambiguous and creates uncertainty for end-users even without de minimis reset

***Takeaway*: Require de minimis threshold to be no less than $8 billion**

NEXTera ENERGY RESOURCES

Swap Regulations Should Not Force State and Municipal Utilities to Hedge Financially Only with Banks

<u>Government-Related Utilities Are Being Forced to Transact Financially Only With Banks</u>

- **Swap dealer de minimis for transactions with special entities is $25 million**
  - CFTC issued guidance raising level to $800 million, but imposed onerous conditions (e.g. not available to "financial entities")
- **Few non-swap dealers will transact financially with government-related utilities (often sophisticated market participants familiar with energy derivatives)**
- **Special entity treatment essentially forces government-related utilities to transact only with large banks that are registered swap dealers or use futures**

***Takeaway*: Adopt H.R. 1038**

NEXTera ENERGY RESOURCES

End-User Exception from Mandatory Clearing Should be Available to Central Desks That Hedge for Affiliates

<u>End-User Exception For Affiliates Needs to be Fixed</u>

- Exception to mandatory clearing for non-financial entities hedging business risks
- An entity may use its affiliates' end-user status to claim the exception, but only if is acting as agent for the affiliate
- Common industry practice is for hedging affiliate to transact as a principal, not as agent
- CFTC interprets statutory language strictly so many entities with central hedge desks may not be eligible for the exception

***<u>Takeaway</u>*: Adopt H.R. 677**

NEXTera ENERGY RESOURCES

Inter-Affiliate Swaps Should be Excluded From Most Swap Regulations

Inter-Affiliate Swaps Do Not Pose Significant Risks

- **CFTC rules generally treat inter-affiliate swaps the same other swaps**
  - Subject to reporting and mandatory clearing unless an exception is met
    - -- CFTC estimated the cost of using the clearing exception for inter-affiliate swaps at almost $700 million (cost based on reporting requirements)
- **Inter-affiliate swaps have little to no impact on swap markets and do not pose significant risks outside of a corporate family**

Takeaway: **Adopt H.R. 677**

NEXTera ENERGY RESOURCES

A Restrictive Definition of Bona Fide Hedging in Position Limit Rules Does Not Further Congress' Intent

Bona Fide Hedging Should Recognize Current Legitimate Hedging Practices

- **CFTC is working on a new position limit rule to replace the vacated rule and has indicated bona fide hedging definition may be even more restrictive**
  - Prior rule required transactions to fit one of eight enumerated categories
- **Legitimate hedging practices are intended to be exempt from speculative position limits**
- **Overly narrow definition of bona fide hedging limits energy companies' ability to hedge and does not further Congressional intent**

***Takeaway*: require CFTC to use a principle-based approach that recognizes current hedging practices**

NEXTera ENERGY RESOURCES

End-Users Should Not Be Subject to Mandatory Margin Requirements for Derivatives

End-Users Should Not Be Required to Margin Uncleared Swaps

- **Banking regulators proposed that swap dealer banks generally must collect margin from all counterparties for uncleared swaps**
  - Very narrow list of acceptable forms of collateral
- **Congress intended that end-users not be subject to margin because end-users do not pose systemic risk and have commercial exposures that often offset derivative positions**

***Takeaway*: Adopt H.R. 634**

NEXTera ENERGY RESOURCES

NEPPA

May 1, 2013

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

The Honorable Thad Cochran, Ranking Member
Committee on Agriculture, Nutrition & Forestry
United States Senate
328A Russell Senate Office Building
Washington, DC 20510

Dear Chair Stabenow and Ranking Member Cochran:

Thank you for the opportunity to provide comments as the Senate Agriculture Committee begins considering reauthorization of the Commodities Exchange Act.

The Northeast Public Power Association (NEPPA) is a trade group representing municipally-owned, public power utilities and co-ops that serve customers in the six New England states. Over the past three years, NEPPA members have worked closely with the Commodity Futures Trading Commission (CFTC) to inform the new derivatives regime put in place by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). With the rules largely finalized, NEPPA members have begun compliance efforts.

We write to bring to your attention, and request relief from, an unintended consequence of the Act that hampers our risk management efforts and those of other municipally-owned utilities. Namely, the swap dealer definition finalized by the CFTC last April has substantially hindered government-owned utilities' ability to hedge against operational risks.

NEPPA Members Hedge to Mitigate Commercial Risk

Public power utilities are sophisticated market participants that engage in swaps activity to hedge legitimate commercial risks. Municipal utilities like NEPPA members depend on nonfinancial commodity transactions, trade options, and "swaps," as well as the futures markets, to hedge commercial risks that arise from their utility facilities, operations, and public service obligations. Nonfinancial commodity markets play a central role in our ability to secure electric energy, fuel for generation, and natural gas supplies for delivery to consumers at reasonable and stable prices.

In hedging, mitigating or managing operational risks, we are engaged in commercial risk management activities that are no different from the operations-related hedging of an investor-owned utility or an electric cooperative located in the same geographic region.

Non-financial Firms Are Necessary Counterparties

Electric energy is unique among commodities because it cannot be stored; it must be used at the time it is produced. Each regional geographic market has a somewhat different set of demands (driven by weather and other factors) and a different group of financial and nonfinancial counterparties available to meet these demands by entering into utility operations-related swaps needed for hedging price and supply risks.

Northeast Public Power Association
200 New Estate Road
Littleton, MA 01460
phone: 978.540.2200
fax: 978.952.7320
www.neppa.org

Owners of electrical generation and distribution facilities – whether investor-owned utilities, municipal or cooperative utilities, or merchant generation companies – operate in their geographical proximity. As they balance their generation to meet changing demands on an hour-to-hour basis, their most likely trading counterparties are other regional market participants. These regional market participants, unlike financial entities, have a vested interest in maintaining the reliability of the electric grid and ensuring that sufficient liquidity exists to manage their operations.

Because there are a limited number of counterparties for any particular operations-related swap, having a variety of counterparties brings important market liquidity and diversity.

The Special Entity "Sub-Threshold" Threatens to Subject End Users to Increased Regulation

Dodd-Frank directed the CFTC to require swap dealers and major swap participants to register and meet strict capital, margin, and reporting and recordkeeping requirements, as well as comply with rigorous business conduct and documentation standards. Congress was concerned that there be a distinction between these market-making entities and end-users that use swaps to hedge commercial risk.

To address those concerns, the Dodd-Frank Act included a "*de minimis* exception" to the definition of a swap dealer, to ensure that the definition captured only those entities engaged in a significant amount of dealing activity. In the proposed rule to define these entities, the CFTC set two separate *de minimis* thresholds relating to the dollar quantity of swaps: $100 million annually for an entity's total swap-dealing activity and $25 million annually for an entity's swap-dealing activity with special entities, which include government owned utilities.

The Not-For-Profit Electric End User Group (NFP EEU) filed comments recommending that the CFTC substantially increase both thresholds. Nevertheless, the final rule greatly increased the overall *de minimis* threshold from the proposed rule, raising it from $100 million to $3 billion, while leaving unchanged the $25 million sub-threshold for swap-dealing activities with special entities.

As a result, nonfinancial entities (such as natural gas producers, independent generators, and investor-owned utility companies) that do not want to be swap dealers, and would otherwise not be captured by the definition, have decided to stop engaging in transactions with government-owned utilities to avoid exceeding the $25 million threshold.

Efforts to Obtain Regulatory Relief Have Been Exhausted

On July 12, 2012, the American Public Power Association (APPA), the Large Public Power Council (LPPC), the American Public Gas Association (APGA), the Transmission Access Policy Study Group (TAPS), and the Bonneville Power Administration (BPA) filed a petition requesting that the CFTC amend its swap-dealer rule to exclude utility operations-related swap transactions from counting towards the special entity threshold.

Instead, the CFTC released a "no-action" letter allowing a counterparty to deal in up to $800 million in swaps with government-owned utilities without being required to register as a swap dealer. The no-action letter, however, also included a number of additional limitations.

The no-action letter has failed to provide nonfinancial counterparties with the assurances they need to enter into swap transactions with municipal utilities. Our traditional counterparties are unwilling to spend the time and money to create a separate compliance process, and adjust their policies and procedures, to facilitate transactions with the small segment of any particular regional market that utility special entities represent.

Several CFTC commissioners have indicated that they believe that relief is appropriate and, absent action by the CFTC, legislation to address this issue directly would be appropriate.

The Public Power Risk Management Act is a Targeted, Technical Correction

On March 11, 2013, Rep. Doug LaMalfa introduced the "*Public Power Risk Management Act of 2013*" (H.R. 1038). The legislation largely mirrors the intent and effect of the NFP EEU petition, providing narrowly targeted relief for operations-related swaps for government-owned utilities. Specifically, the legislation would provide that the CFTC, in making a determination to exempt a swap dealer under the *de minimis* exception, shall treat a utility operations-related swap with a utility special entity the same as a utility operations-related swaps with any entity that is not a special entity.

The legislation carefully defines which entities would qualify as a "utility special entity." It also specifically defines the types of swaps that could and could not be considered a "utility operations-related swap." For example, the legislation specifically prohibits interest, credit, equity, and currency swaps from being considered as a utility operations-related swap. Likewise, except in relation to their use as a fuel, commodity swaps in metal, agricultural, crude oil, or gasoline would not qualify either. Finally, the legislation also confirms that utility operations-related swaps are fully subject to swap reporting requirements.

When implemented, this legislation should provide certainty to nonfinancial entities that they can enter into swap transactions with government-owned utilities without fear of being deemed a swap dealer.

We strongly request that you support inclusion of this legislation as part of a CFTC reauthorization.

Sincerely,

Lawrence Brownell
Executive Director
NEPPA

Premier Metal Services, LLC.

Summary

Re: Summary of Premier Metal Services, LLC's Comments in Response to the Request for Comment on the Reauthorization of the Commodity Futures Trading Commission, Market oversight, Agency Oversight and Resources, Statutory Authority and Copper ETFs (Exchange Traded Funds) March 7, 2013.

Content

Comment Letter Reauthorization of the Commodity Futures Trading Commission.

(i) Brief introduction to the scrap recycling industry;

(ii) Discussion of the critical role that bona fide hedging serves in the scrap recycling and metals industries;

(iii) Discussion of several critical issues that remain for "Customers" who engage in hedging and must maintain Segregated Accounts whether or not the CFTC Proposed Enhancements[i] are enacted;

(iv) Discussion of the important oversight role of the CFTC and statement in support of CFTC Reauthorization; and

(v) Discussion of the risks that are faced by metals industry participants by permitting the creation and trading of Copper ETFs.

Exhibit List

Exhibit A. Comment Letter filed by Premier Metal Services, LLC on Proposed Rulemaking Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations. (RIN 3038-AD88, 77 Fed. Reg. 67866, November 14, 2012 and 78 Fed. Reg. 4093, January 18, 2013.) Dated January 3, 2013.

Exhibit B. Comment Letter filed by the Institute of Scrap Recycling Industries on Proposed Rulemaking Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations. (RIN 3038-AD88, 77 Fed. Reg. 67866, November 14, 2012 and 78 Fed. Reg. 4093, January 18, 2013.) Dated December 4, 2012.

Exhibit C. "The End User Bill of Rights" Statement of Commissioner Bart Chilton, April 3, 2013. Paragraph No. 4.

33565 Bainbridge Road, Solon, Ohio 44139 ◆ P.O. Box 39336, Solon, Ohio 44139
Phone: 216.409.2129 ◆ Fax: 216.359.0090
www.premiermetalservices.com
ISO 9001

Exhibit D. "SEC ignored risks posed by copper ETF: Southwire." Andrea Hotter, American Metal Market, March 26, 2013.

Exhibit E. "In-warehouse copper premiums skyrocket." Suzy Waite, American Metal Market, April 18, 2013.

Exhibit F. "Copper mine outage sparks shift to scrap." Barbara O'Donovan, American Metal Market, April 18, 2013.

---

[i] Proposed Rulemaking Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations. (RIN 3038-AD88, 77 Fed. Reg. 67866, November 14, 2012 and 78 Fed. Reg. 4093, January 18, 2013.)

Premier Metal Services, LLC.

April 29, 2013

Via Electronic Submission

Senator Debbie Stabenow, Chairwoman
Senator Thad Cochran, Ranking Member
Committee Members
United States Senate
Committee on Agriculture, Nutrition and Forestry
Washington, D.C. 20510-6000

Re: Request for Comment on the Reauthorization of the Commodity Futures Trading Commission, Market oversight, Agency Oversight and Resources, Statutory Authority and Copper ETFs (Exchange Traded Funds) March 7, 2013.

I. Introduction

Premier Metal Services, LLC ("Premier") is a privately held broker and processor of metals. The vast majority of the metal products that Premier brokers, processes and trades are nonferrous scrap metals such as copper, aluminum, and zinc. Premier is engaged in both the import and export of metals. Premier greatly appreciates this opportunity to comment on the above stated topics and respectfully submits this comment letter (the "Comment Letter") in response to the Request for Input-Senate Ag-CFTC Reauthorization dated March 7, 2013 (the "CFTC Reauthorization") issued by the United States Senate, Committee on Agriculture, Nutrition and Forestry. In addition to the comments related to CFTC Reauthorization, this Comment Letter will discuss Copper ETFs (Exchange Traded Funds) recently approved by the Securities and Exchange Commission. More specifically, Premier's comments will be limited to (i) a brief introduction to the scrap recycling industry; (ii) a discussion of the critical role that bona fide hedging serves in the scrap recycling and metals industries; (iii) a discussion of several critical issues that remain for "Customers" who engage in hedging and must maintain Segregated Accounts whether or not the CFTC Proposed Enhancements[1] are enacted; (iv) a discussion of the important oversight role of the CFTC and statement in support of CFTC Reauthorization;

33565 Bainbridge Road, Solon, Ohio 44139 P.O. Box 39336, Solon, Ohio 44139
Phone: 216.409.2129 Fax: 216.359.0090
www.premiermetalservices.com
ISO 9001

and (v) a discussion of the risks that are faced by metals industry participants by permitting the creation and trading of Copper ETFs.

Premier has taken an active role in leading an initiative of metals industry companies that are similarly situated in an effort to provide the CFTC with an introduction to the recycling industry and an understanding of the metals industry's significant role in commodity futures trading. The initiative is reflected by the filing of Premier's Comment Letter, Comment No. 59024, dated January 3, 2013, attached as **Exhibit A**, and the Comment Letter filed by the Institute of Scrap Recycling Industries (ISRI), on behalf of its members on December 4, 2012, Comment Number 58962, attached as **Exhibit B**. Premier utilizes bona fide hedging on the futures exchanges as a risk mitigation tool in the ordinary course of its business. As further described below, hedging plays a critical role in the metals recycling industry not only as it relates to the trading of various grades of scrap metal, but also as it relates to those manufacturers that consume, produce, and fabricate metals.

II. Introduction to the Scrap Recycling Industry

The recycling industry is comprised of businesses engaged in the recycling of various commodities such as metals, plastics, glass, paper, rubber, textiles and electronics. Members of ISRI, a Washington, D.C. based trade association representing the scrap recycling industry, are involved in the processing, collecting, trading and consuming of these commodities; for all intents and purposes the scrap recycling industry is the first link in the manufacturing chain. The scrap recycling industry produced approximately $100 Billion worth of commodities last year, which is equal to roughly 0.6 percent of GDP,[2] and is similar in size to the nation's forestry and fishing industries combined, nearly all of the nation's professional sports teams and the toy industry. In 2011, scrap recycling brokers and processors provided in excess of 459,000 jobs directly and indirectly.[3] Hedging metals' prices on commodity futures exchanges as a risk mitigation tool is a critical component of the financial and risk management activities conducted by scrap metal recyclers ("Metals Recyclers").

In addition to the impact on the domestic economy, the value of scrap exported by the scrap recycling industry in 2011 increased 32% to approach $40 Billion in export sales to 161 Countries.[4] Likewise, by value, scrap exports are one of the top 5 exports from the United States.[5] Many of the commodities traded by Metals Recyclers are also traded on commodity futures exchanges throughout the world. Hedging is widely used as a risk mitigation tool against metals' price volatility and serves to provide liquidity for the metals recycling industry. Within the metals producing, consuming and scrap industries, there is often a significant time lapse that occurs from the time metal is produced, bought, sold, shipped and consumed by an end-user. This is especially cogent because so many metals are shipped all over the world. Specifically, these commodities, such as copper, aluminum, steel, zinc, and tin, among others, are critical raw materials for both emerging markets as well as mature economies.

III. Hedging: Risk Mitigation in the Scrap Metal Recycling Industry

The hedging of metals prices by Metals Recyclers is "bona fide hedging" as defined under the Act[6] and is in contrast to the often erroneous use and application of the term "hedging" to other financial investment instruments and activities. Bona fide hedging is encouraged in many industries especially with respect to agriculture, and energy. However, the metals industry, and more specifically, the scrap metal recycling industry has not heretofore provided its input on the many issues exposed by the collapse of MF Global.

As mentioned above, Metals Recyclers use hedging on the commodity futures exchanges to mitigate the risk of exposure to metals' pricing volatility. In addition to hedging on domestic exchanges, Metals Recyclers hedge a considerable volume of aluminum and other nonferrous metals through U. S. based FCMs on the London Metal Exchange. As a practical matter, Metals Recyclers hedge to ensure, on some level, that the risk of the transaction is removed. Metals Recyclers maintain Segregated Accounts comprised of commodity exchange mandated margin requirements, and cash proceeds typically resulting from changes in trading positions and/or market fluctuations. The margin requirements that are mandated by the commodity exchange serve as collateral for a Metals Recycler's trading activities. Inherently, the Metals Recycler, who is hedging, seeks to reduce the risk of exposure to the market and is not assuming risk with respect to its collateral account. This is in contrast to those who engage in speculative trading on commodity exchanges. Speculators do assume risk of exposure from their trading activities.

IV. Critical Open Issues and Suggestions for Resolution Proposed to the CFTC Market Oversight, Agency Oversight and Resources, Statutory Authority

In order for the markets to function efficiently, Commodity Customers must have confidence and trust in the market's financial safeguards. Specifically, in the absence of an FDIC or SIPC insurance type of regime, market participants must have a level of trust and confidence that there will not be a repeat of the circumstances involved in the collapse of MF Global and Peregrine. We applaud the CFTC for taking such strong measures in connection with the Enhanced Customer Protections (the "Proposal") RIN 3038-AD88, 77 Fed. Reg. 67866, November 14, 2012. However, there remain critical open issues of concern involving: (i) FCMs continued unfettered access to pool Customer Funds then hypothecate and re-hypothecate those funds for their own benefit, including, but not limited to FCMs' ability to transfer those funds to overseas subsidiaries to avoid compliance with U.S. regulations; (ii) the scope of investments that FCMs are still permitted to make under the Act; and (iii) the "permitted language" in Commodity Customer Agreements (the "Agreements") that grant FCMs such unreasonably wide latitude to use and invest Customer Funds. For a more in-depth discussion of these open issues, including the adhesion contract language in Commodity Customer Agreements, *please see* **Exhibits A and B**.

Although the Proposal seeks to create a higher level of trust and confidence that Customer Funds will not be put at risk by the FCMs, the Proposal contains no provisions that provide Commodity Customers with an option to "opt out" of granting FCMs access to their collateral. The FCMs appear to have no incentive to encourage them to negotiate alternative segregation arrangements for Commodity Customers. Nor are there any consequences set forth that would penalize FCMs for coercing Commodity Customers to agree to those conditions. Likewise, there are no regulations that provide Commodity Customers with rights to decline those conditions or negotiate more mutually agreeable terms.

We asked the CFTC to mandate that FCMs provide Commodity Customers the option to "opt out" of granting FCMs access to invest Customer Funds including hypothecation and re-hypothecation of those Customer Funds, yet permit those Commodity Customers to continue to actively trade. Alternatively, or in conjunction with an "opt out" provision we also asked the CFTC to consider further enhancements to customer protections that would provide FCMs with an incentive or some reasonable mechanism to negotiate and modify these terms of concern. Alternatively, for those Commodity Customers that elect not to grant such wide latitude to FCMs, mandate that margin money be held in the name of Commodity Customers in accounts, and/or securities, or investment instruments that are identifiable and insurable and prohibit FCMs from transferring funds to foreign subsidiaries to avoid compliance with U.S. regulations.

Since filing the Comment Letters, attached as **Exhibits A and B**, we have had the opportunity to meet with CFTC Officials on two occasions to discuss these and other issues. Not only did these Officials show a strong interest in learning about our industry and our business model, they showed a keen interest in the issues and potential resolutions we proposed. Specifically, the "opt-out" or "alternative segregation arrangements" that we originally proposed in our Comment Letters[7] seems to have risen from obscurity to now being part of the discussion. *Please see* **Exhibit C**. "The End User Bill of Rights" Statement of Commissioner Bart Chilton, April 3, 2013. Paragraph No. 4.

V. Importance of the Role of the CFTC

The collapse of both MF Global and Peregrine exposed systemic problems within the commodity futures trading industry and its self-regulatory oversight regime. Commodity futures remain the only financial market where participants have no statutory insurance system. The CFTC's oversight is critical given, among other things, the composition of futures markets' participants. Generally speaking, there are two significant, yet often, diametrically opposed participants, speculators and bona fide hedgers. It is important to draw this distinction, despite the systemic issues because the participants play an important role in providing liquidity to the market and as such, the futures markets tend to function efficiently.

Speculators are attempting to predict and profit on a movement in pricing of a particular commodity at a particular point in time. Speculators assume an inherent risk to losing all funds on account, however, they also stand to gain if their bet is correct. On the other hand, companies using the commodity exchanges for the purpose of engaging in risk mitigation are employing hedging as a tool and do not assume the same inherent risk of loss that speculators assume. In the absence of hedging, metals merchants, consumers, and processors are exposed to the volatility of price fluctuations which could have a devastating financial impact on a business.

Although we have argued above that the proposed enhancements to customer protections should go further, we strongly believe that without the critical role that the CFTC plays, there would clearly be even greater abuses in the marketplace and the countless farmers, livestock, energy, metals, etc., currently maintaining a risk mitigation program, would be without any protections. We strongly support the reauthorization of the CFTC and strongly suggest that appropriate budgetary levels are provided so that the CFTC can obtain proper levels of staff to manage its oversight and enforcement responsibilities especially in light of the additional duties under Dodd Frank.

VI. Copper ETFs

A. Copper Basics

The discussion of Copper ETFs contained herein represents our views on the potential danger that Copper ETFs pose to a multitude of industries and ultimately, the United States' economy. The creation and implementation of Copper ETFs will create distortions in the copper marketplace and will invite manipulation of copper prices and copper availability. Copper is widely used as a raw material in many consumer products, U. S. infrastructure development, electric power generation, housing, and defense among other areas of critical economic importance. Copper is not only mined, it is also one of the most widely recycled metals in the world. Copper is traded on a number of commodity exchanges around the world, the London Metal Exchange, the Shanghai Metal Exchange and the Chicago Mercantile Exchange (the "COMEX"), to name a few. Copper cathode is inventoried and stored in exchange approved warehouses ("Exchange Warehouses").

Historically, Copper pricing was determined based on supply and demand fundamentals, however, the last decade or so saw external or non-industry participants influence copper pricing through, among other things, speculation. Copper is attractive to speculators and investors because it is viewed as an indicator of economic activity. Fundamentally, as copper usage increases it tends to reflect robust economic activity. When copper demand and usage increases, the price of copper rises. As a practical matter, copper prices are also affected by the availability of physical copper. Currently, although copper inventories are relatively higher, copper availability is greatly diminished as discussed below. Add speculation and external investor interest to the basic demand-supply equation and the swings in copper prices become more volatile. Physical copper held in inventory that is kept off the market is unavailable for industrial use.

There are further limitations on the availability of copper cathode and copper scrap. Copper cathode is produced from mined copper ore, yet the processes require considerable long-term capital outlays and sizeable operating costs. Copper supply is supplemented by recycled scrap metals such as copper, brass and bronze. Although there are capital expenditures required for recycling copper scrap, those costs are significantly lower than mining copper and producing cathode. Recycling copper scrap also provides an efficient and environmentally positive allocation of resources. That being said, there remains a finite level of copper available for industrial uses.

B. Issues: An Invitation for Manipulation and Abuse

Copper ETFs pose a number of potential dangers to an already delicate copper market. These dangers not only impact price but also impact the availability of physical copper for manufacturing and industrial applications. Copper ETFs will be supported or backed by physical copper held in inventories. A multitude of issues exist, but for the purposes of this comment only a few issues will be highlighted.

i. Common Control

Currently, owning Exchange Warehouses has been a lucrative business for investment banks. These same investment banks have sought regulatory approval to market and trade Copper ETFs. *See* **Exhibit D** "SEC ignored risks posed by copper ETF: Southwire." The potential to own the Exchange Warehouses storing copper cathode and trade in funds supported by those inventory stocks invites manipulation, market distortions and a concentrated control over a limited resource critical to the U.S. economy. Too much control in too few hands for a widely used resource is a recipe for disaster. Despite whether the entities that own the Exchange Warehouses are legally separate from those marketing and trading ETFs, the distinction is only a legal distinction. The fact of the matter is that both entities are subsidiaries and/or affiliates of the same organization. Over the course of the last six years or so, we have all been witness to rampant market manipulation and the excuses that use "subsidiaries and affiliates" to hide behind legal distinctions to justify or excuse bad behavior. Those entities will profit from holding material in the Exchange Warehouses and will profit from the movements in copper prices, which, as discussed, are impacted by physical copper's availability in the marketplace. As is commonly recognized by the investment community, profits can be made from rising or falling prices.

ii. Market Distortions and Availability of Copper

As of the date of this comment, there are severe distortions occurring in the copper market. There are a series of articles from the American Metal Market discussing the impact of a natural disaster on copper supply, availability and pricing. *See* **Exhibit E** "In-warehouse copper premiums skyrocket." The articles reflect that premiums increase with a decrease in availability and supply. Although copper inventory stocks are supposedly very high, the actual physical metal is not available to end users. In other words, those industries that need to meet their respective production requirements cannot readily obtain copper cathode. As discussed in the article attached as **Exhibit F** "Copper mine outage sparks shift to scrap." there are increasingly long waits to remove copper from Exchange Warehouses. Again, these Exchange Warehouses are owned by the same investment banks who want to create the Copper ETFs. Some of the Exchange Warehouses have a year-long wait, yet copper and brass mills, manufacturers and end users require delivery of raw materials to meet their respective production requirements. Consumers of copper cathode who are able to use copper scrap as a replacement will reach into the scrap metal market for additional supply. Likewise, there is not an infinite supply of copper scrap; as a result, the price of copper scrap also increases as its demand and consumption increases. Although these movements reflect supply-demand fundamentals, the origin of these issues can be directly traced to the inability to obtain copper cathode on a timely basis from Exchange Warehouses. The longer period of time that copper cathode remains in Exchange Warehouses, higher profits are yielded by those same Exchange Warehouse owners. Accordingly, there is an incentive to delay copper cathode from reaching or supplying the physical copper marketplace.

If copper stored in warehouses is used to back Copper ETFs, as a practical matter, it will not be available for use in the marketplace. Or at the very least, it can be withheld from the marketplace to create a greater demand and/or manipulate copper prices. As mentioned above, the incentive for Exchange Warehouse owners and those investment banks making a market in Copper ETFs is to withhold copper cathode from the physical marketplace. However, the risk to the U.S. economy, manufacturing, electric power generation, and U.S. Consumers, among others, cannot be over-stated. Permitting Copper ETFs places a significant amount of control and influence in the hands of only a few for such a vital raw material. If manufacturers cannot reasonably acquire raw materials to meet production needs, then manufacturers will either relocate where they can obtain raw materials, or cease to exist which means not only the further erosion of manufacturing but even more critical the loss of valuable manufacturing jobs.

Furthermore, the argument that Precious Metals based ETFs are successful so Copper ETFs will also be successful is greatly flawed. As discussed above, copper is a vital raw material used in electric power generation, automobile production, home building, commercial construction, manufacturing of durable goods, consumer electronics, and many other areas. Copper is relied upon as a raw material or a component in countless products. Contrast the wide use of copper with precious metals' use, copper availability has a much broader impact to the economy and jobs.

The debate over whether Copper ETFs should be permitted seems to be a classic case of "Wall Street v. Main Street." Do we allow a few investment banks to effectively control a vital raw material and risk already delicate manufacturing jobs and manufacturing capability, or do we make prudent decisions that support vital U.S. manufacturing and valuable U.S. jobs? It seems logical that deference should be afforded the broader economy as opposed to exposing a significant resource to potential manipulation and abuse.

VII. Conclusion

As mentioned above, bona fide hedging employed as a risk mitigation tool protects metals industry participants and Premier's business against exposure to the volatility of metals pricing; similar in purpose and practice to hedging programs employed in the agriculture industry. Bona fide hedging programs are encouraged under the spirit of the Act. Segregated Accounts are the mechanism used to hold initial and variable margin money required to be held on account as collateral with clearing firms. We have asked the CFTC to give full and careful consideration to our requests concerning the critical open issues discussed in Section IV. We support reauthorization of the CFTC and appropriate resources for the CFTC to accomplish its mandates. We also thank the CFTC for taking so many necessary steps to ensure that Commodity Customers' collateral held by FCMs is safe and secure. In order for the market to operate efficiently there must be confidence and mutual trust, neither of which exists right now as a lasting result of the collapse of MF Global and Peregrine.

Additionally, we are deeply concerned that the creation and implementation of Copper ETFs poses a significant risk to those industries that consume, produce, fabricate and manufacture products out of copper and/or copper based products. Likewise, those risks have a direct impact on the U.S. economy as a whole. Copper is too vital a raw material to invite the potential for manipulation and abuse that Copper ETFs pose. The potential negative impact will be irreversible.

Sincerely,

Michael Eisner, President

Mark A. Weintraub, Esq., In-house Counsel

---

[1] Proposed Rulemaking Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations. (RIN 3038-AD88, 77 Fed. Reg. 67866, November 14, 2012 and 78 Fed. Reg. 4093, January 18, 2013.)

[2] In 2011, ISRI retained the independent consulting firm of John Dunham and Assoc. to perform an economic impact analysis of the scrap recycling industry on the U.S. economy. The statistics are based on the Economic Impact of the Scrap Recycling Industry in the United States (2011), produced for ISRI, by John Dunham and Associates, 2011.

[3] Scrap Recycling Industry Impact Methodology Summary, John Dunham and Associates, 2011.

[4] The United States Census Bureau and the United States International Trade Commission.

[5] The United States Census Bureau and the United States International Trade Commission.

[6] 7 U.S.C § 6a.

[7] *See* Exhibits A & B.

EXHIBIT A

Premier Metal Services, LLC.

January 3, 2013

Via Electronic Submission

Gary Barnett, Director
Division of Swap Dealer and Intermediary Oversight
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Comments on Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations. (RIN 3038-AD88, 77 Fed. Reg. 67866, November 14, 2012)

I. Introduction

Premier Metal Services, LLC ("Premier") is a privately held broker and processor of metals. The vast majority of the metal products that Premier brokers, processes and trades are nonferrous metals such as copper, aluminum, and zinc. Premier is engaged in both the import and export of metals. Premier respectfully submits these comments in response to the Notice of Proposed Rulemaking (the "Proposal") on Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations ("Enhanced Customer Protections"). Premier utilizes bona fide hedging as a risk mitigation tool in the ordinary course of business. Never did we consider that the collateral we were required to post for our trading account would itself be put at risk. Although we reserve the right for further comment, Premier's comments in this letter will be limited to (i) discussing several critical issues that had not been addressed in the Proposal; (ii) offering support for the Proposal for the Enhanced Customer Protections; and (iii) offering full support for the Comment Letter filed by the Institute of Scrap Recycling Industries (ISRI), on behalf of its members on December 4, 2012, Comment Number 58962, and introducing the CFTC to the recycling industry and its significant role in commodity futures trading.

33565 Bainbridge Road, Solon, Ohio 44139 ◆ P.O. Box 39336, Solon, Ohio 44139
Phone: 440.519.1104 ◆ Fax: 216.359.0090
www.premiermetalservices.com
AN ISO 9001 COMPANY

II. Critical Open Issues and Suggestions for Resolution

In order for the markets to function efficiently, commodity customers must have confidence and trust in the market's financial safeguards. Specifically, in the absence of an FDIC or SIPC insurance type of regime, market participants must have a level of trust and confidence that there will not be a repeat of the circumstances involved in the collapse of MF Global and Peregrine. We applaud the CFTC for taking such strong measures in connection with the Enhanced Customer Protections and we fully support all of the proposals contained in RIN 3038-AD88, 77 Fed. Reg. 67866, November 14, 2012. However, there remain critical open issues of concern involving: (i) FCMs continued unfettered access to pool Customer Funds then hypothecate and re-hypothecate those funds for their own benefit, including, but not limited to FCMs' ability to transfer those funds to overseas subsidiaries to avoid compliance with U.S. regulations; (ii) the scope of investments that FCMs are still permitted to make under the Act; and (iii) the "permitted language" in Commodity Customer Agreements (the "Agreements") that grant FCMs such unreasonably wide latitude to use and invest Customer Funds.

The language that is typically found in Agreements permitting an FCM to use Customer Funds, at the FCM's discretion (or whim), is buried deep within the Agreement. In order to open a commodity trading account with a particular FCM, a Commodity Customer must comply with such a clause. Below is a clause taken from an FCM's Agreement packet and two examples are attached as **Exhibit A**.

> Except as prohibited by Applicable Law, all collateral now or hereafter held or carried by the clearing firm (CF) for customer may, from time to time, without notice to customer, be pledged, hypothecated, loaned or invested by CF to or with CF or others, separately or with any other property. CF shall not be required to retain in its possession for delivery a like amount of, or to pay interest or to account to customer for any profits on, such property. All transactions for or on customers behalf may be included in a single account whether or not such transactions are segregated on CF's records into separate accounts, either severally or jointly with others.[1]

This common clause skirts the spirit of the Act by granting wide latitude to the FCM to use Customer Funds, which the Commodity Customer is required to post for initial and variable margin. Allowing an FCM unfettered use of Customer Funds without a mechanism for such funds to be guaranteed or insured exposes those Customer Funds to risk of loss. The Enhanced Customer Protections do take a significant step towards reducing that risk and potentially providing an early warning mechanism for alerting the CFTC, Commodity Customers, and other oversight entities of the possibility that certain precarious issues may arise. Yet, the

Regulations still prohibit a Commodity Customer from placing margin in a security account or financial instrument that is maintained in the name of the Commodity Customer and is both identifiable and insurable by SIPC or a bank account that is otherwise insured by the FDIC.

Commissioner Chilton has publically endorsed the creation of an insurance regime, which we welcome and endorse as well. However, an insurance regime limited to the amount of $250,000, as proposed, is inadequate given the margin requirements of most trading accounts, even small accounts. Premier would recommend that an insurable level be determined based on an analysis of average levels held in margin accounts of a reasonable historical period.

Often, unknowingly, Commodity Customers acquiesce to these clauses which are buried deep within a forty or fifty page Agreement. Recognizing that a Commodity Customer must understand the terms of the Agreement, if a Commodity Customer wanted to modify or did not want to grant the FCM the rights as stated in that clause, Commodity Customers are powerless to negotiate changes -- the Agreements are nothing less than contracts of adhesion with regard to all except, perhaps, the very largest Customers.

Below are some examples of terms or modifications to Commodity Customer Agreements that were actually proposed and rejected:

1) Require FCMs to provide an alternative to granting them discretionary ability to pool and invest Customer Funds with the full understanding that transaction costs may increase.
2) Allow segregated margin funds for hedge accounts to be swept nightly into a securities account that is insurable by SIPC, and/or a commercial bank account insured by the FDIC.
3) Allow U.S. Treasury Notes, a permissible instrument to post as margin, to be held in the name of the Commodity Customer, and perhaps consider permitting a UCC filing.
4) Modify the scope of SIPC to include Customer funds insured up to a statutory limitation.

As noted above, several of the aforementioned concepts were presented to FCMs in the period following the collapse of MF Global when Commodity Customers were seeking to re-open accounts which were previously at MF Global and that had been transferred to another FCM. The response from the FCMs was that the terms of the Agreements were non-negotiable. Admittedly, some or all of the above suggestions would require FCMs to modify or forego their ability to speculate with Commodity Customers' Segregated Accounts holding margin requirements. However, from a Customer's point of view, these suggestions would go a long way towards leveling the playing field.

The FCMs appear to have no incentive to encourage them to negotiate certain terms of the Agreements with Commodity Customers. Nor are there any consequences set forth that would penalize FCMs for coercing Commodity Customers to agree to those conditions. Likewise, there are no regulations that provide Commodity Customers with rights to decline those conditions or negotiate more mutually agreeable terms. As discussed above, Commodity Customers have attempted to negotiate modifications to the Agreements, however, the responses received indicate that the Commodity Customers, if they want to continue to have an open and active account, must acquiesce.

As mentioned above, Premier would clearly prefer that FCMs not have the ability to invest Customer Funds for the FCMs' benefit. Although the Proposal seeks to create a higher level of trust and confidence that Customer Funds will not be put at risk by the FCMs, the Proposal contains no provisions that provide Commodity Customers with an option to "opt out" of granting FCMs access to their collateral.

We ask the CFTC to mandate that FCMs provide Commodity Customers the option to "opt out" of granting FCMs access to invest Customer Funds including hypothecation and re-hypothecation of those Customer Funds, yet permit those Commodity Customers to continue to actively trade. Alternatively, or in conjunction with an "opt out" provision we are asking the CFTC to consider further enhancements to customer protections that would provide FCMs with an incentive or some reasonable mechanism to negotiate and modify these terms of concern for those Commodity Customers that elect not to grant such wide latitude as is represented by the aforementioned Agreement clause. Mandate that margin money be held in the name of Commodity Customers in accounts, and/or securities, or investment instruments that are identifiable and insurable. Prohibit FCMs from transferring funds to foreign subsidiaries to avoid compliance with U.S. regulations. Examples of reasonable modifications are listed on the prior page.

III. <u>"Enhanced Customer Protection Proposal" Comments</u>

Premier is a business engaged in bona fide hedging as defined under the Act and fully supports the Enhanced Customer Protections. As proposed, the Enhanced Customer Protections do provide a much higher level of customer protection. We recognize that many of the CFTC's requests for specific comments involve assessment of the projected costs that will be incurred by FCMs and we have elected not to comment on those requests. It is our position, from the Commodity Customers' perspective, that the Enhanced Customer Protections proposed by the CFTC and endorsed by Chairman Gensler[2] clearly serve to achieve their stated goals and we support the Enhanced Customer Protections.

IV. Institute of Scrap Recycling Industries Comment Letter (Portions Restated)

ISRI is a Washington, D.C. based trade association representing the scrap recycling industry. The industry is comprised of businesses engaged in the recycling of various commodities such as metals, plastics, glass, paper, rubber, textiles and electronics. Members of ISRI are involved in the processing, collection, trading and consuming of these commodities; for all intents and purposes the industry is the first link in the manufacturing chain. The scrap recycling industry produced approximately $100 Billion worth of commodities last year, which is equal to roughly 0.6 percent of GDP,[3] and is similar in size to the nation's forestry and fishing industries combined, nearly all of the nation's professional sports teams and the toy industry. In 2011, scrap recycling brokers and processors provided in excess of 459,000 jobs directly and indirectly.[4] Hedging metals' prices on commodity futures exchanges as a risk mitigation tool is a critical component of the financial and risk management activities conducted by scrap metal recyclers ("Metals Recyclers").

In addition to the impact on the domestic economy, the value of scrap exported by the scrap recycling industry in 2011 increased 32% to approach $40 Billion in export sales to 161 Countries.[5] Likewise, by value, scrap exports are one of the top 5 exports from the United States.[6] Many of the commodities traded by Metals Recyclers are also traded on commodity futures exchanges throughout the world. Hedging is widely used as a risk mitigation tool against metals' price volatility and serves to provide liquidity for the metals recycling industry. Within the metals producing, consuming and scrap industries, there is often a significant time lapse that occurs from the time metal is produced, bought, sold, shipped and consumed by an end-user. This is especially cogent because so many metals are shipped all over the world. Specifically, these commodities, such as copper, aluminum, steel, zinc, and tin, among others, are critical raw materials for both emerging markets as well as mature economies.

The collapse of MF Global exposed several systemic problems within the commodity futures trading industry and its oversight regime. According to the Staff Report Prepared for Rep. Randy Neugebauer, Chairman of the Subcommittee on Oversight & Investigations, Committee on Financial Services, and dated November 15, 2012, there is still in excess of ***$665 Million*** missing from Commodity Customers' accounts used for foreign trading, and likely in excess of ***$100 Million*** still missing from domestic accounts.[7] Although the Trustee overseeing the U.S. insolvency proceeding announced further distributions, many Metals Recyclers, as well as their suppliers, customers and consumers continue to represent a significant portion of missing funds in the U.K. insolvency proceedings. It is uncertain whether any of those remaining missing funds will be recovered; and much is now tied up in overseas legal battles stemming from the MF Global U.K. insolvency proceedings.

V. Hedging: Risk Mitigation in the Scrap Metal Recycling Industry

The hedging of metals prices by Metals Recyclers is "bona fide hedging" as defined under the Act[8] and is in contrast to the often erroneous use and application of the term hedging to other financial investment instruments and activities. Bona fide hedging is encouraged in many industries especially with respect to agriculture, and energy. However, the metals industry, and more specifically, the scrap metal recycling industry has not heretofore provided its input on the many issues exposed by the collapse of MF Global.

As mentioned above, Metals Recyclers use hedging on the commodity futures exchanges to mitigate the risk of exposure to metals' pricing volatility. In addition to hedging on domestic exchanges, Metals Recyclers hedge a considerable volume of aluminum and other nonferrous metals through U. S. based FCMs on the London Metal Exchange. As a practical matter, Metals Recyclers hedge to ensure, on some level, that the risk of the transaction is removed. Metals Recyclers maintain Segregated Accounts comprised of commodity exchange mandated margin requirements, and cash proceeds typically resulting from changes in trading positions and/or market fluctuations. The margin requirements mandated by the commodity exchange serve as collateral for a Metals Recycler's trading activities. Inherently, the Metals Recycler, who is hedging, seeks to reduce the risk of exposure to the market and is not assuming risk with respect to its collateral account.

VI. Conclusion

As mentioned above, bona fide hedging employed as a risk mitigation tool protects Premier's business against exposure to the volatility of metals pricing; similar in purpose and practice to hedging programs employed in the agriculture industry. Bona fide hedging programs are encouraged under the spirit of the Act. Segregated Accounts were the mechanism used to hold initial and variable margin money required to be held on account as collateral with clearing firms. We ask the CFTC to give full and careful consideration to our requests concerning the critical open issues discussed in Section II. We thank the CFTC for taking so many necessary steps to ensure that Commodity Customers' collateral held by FCMs is safe and secure. In order for the market to operate efficiently there must be confidence and mutual trust, neither of which exists right now as a lasting result of the collapse of MF Global and Peregrine.

Sincerely,

Michael Eisner, President

Mark A. Weintraub, Esq., In-house Counsel

[1] Similar, if not exact, language exists on Commodity Customer Agreements from all FCMs, including MF Global.
[2]Summary of the Enhanced Customer Protections was compiled from the CFTC Release: PR6396-12 dated October 23, 2012, and Chairman Gensler's Statement of Support dated October 23, 2012.

[3] In 2011, ISRI retained the independent consulting firm of John Dunham and Assoc. to perform an economic impact analysis of the scrap recycling industry on the U.S. economy. The statistics are based on the Economic Impact of the Scrap Recycling Industry in the United States (2011), produced for ISRI, by John Dunham and Associates, 2011.
[4] Scrap Recycling Industry Impact Methodology Summary, John Dunham and Associates, 2011.
[5] The United States Census Bureau and the United States International Trade Commission.
[6] The United States Census Bureau and the United States International Trade Commission.
[7] Staff Report Prepared for Rep. Randy Neugebauer, Chairman, Subcommittee on Oversight & Investigations, Committee on Financial Services, 112th Congress, November 15, 2012, p 73-74.
[8] 7 U.S.C § 6a.

R.J.O'Brien

ACCOUNT AGREEMENT

1. ACCOUNT STATUS

This Account Agreement ("Agreement") sets forth the terms and conditions upon which R.J. O'Brien & Associates, LLC ("R.J. O'Brien") will accept and maintain for the undersigned Customer one or more accounts and act as broker or dealer for Customer in the execution and clearance of orders for transactions (whether domestic or foreign) involving the purchase and sale of futures contracts; options on futures contracts; commodities and forward contracts, security futures contracts ("SSF"); option, spot and forward foreign exchange transactions; exchange for physicals ("EFPs"); and any other cash transaction or derivative, or any similar instruments which may be purchases, sold or cleared by or through an FCM (individually, a "Contract" and collectively, "Contracts"). Customer hereby represents that all responses made in connection with the Account Application and this Agreement are complete and correct, and that R.J. O'Brien will be informed of any material change in such data, including financial information.

If this account has been introduced to us, all references to us in this Agreement shall include your broker, and your broker shall enjoy all benefits and rights hereunder. Customer agrees and acknowledges that broker and R.J. O'Brien may share information with each other regarding or relating to Customer and/or Customer's account (s). Customer warrants to R.J. O'Brien that if Customer is an individual or if this is a joint account, Customer (s) is of legal age and of sound mind. Unless otherwise indicated in the Application, no one except the Customer (s) identified in the Account Application has an interest in the account (s). Customer agrees to permit verification of relevant information by R.J. O'Brien through third parties (including credit reporting entities). In any event, this Agreement and the account (s) permitted hereunder become effective only upon acceptance by an authorized representative of R.J. O'Brien at its principal office in Chicago, Illinois.

2. ACCOUNT RISKS

A.) TRADING IN CONTRACTS IS HIGHLY SPECULATIVE AND IN NO SENSE MAY BE CONSIDERED A CONSERVATIVE INVESTMENT;

B.) BECAUSE OF THE LOW MARGIN DEPOSITS NORMALLY UTILIZED AND THE VOLATILE PRICE MOVEMENTS WHICH CAN OCCUR IN THE MARKETS FOR CONTRACTS, THE POSSIBILITY OF RAPID AND SUBSTANTIAL LOSSES IS CONTINUALLY PRESENT;

C.) TRADING IN CONTRACTS IS APPROPRIATE ONLY FOR THOSE PERSONS FINANCIALLY ABLE TO WITHSTAND SUBSTANTIAL LOSSES, SOMETIMES GREATLY EXCEEDING THE VALUE OF THEIR MARGIN DEPOSITS; AND

D.) NO ONE (INCLUDING FUTURES COMMISSION MERCHANTS , ASSOCIATED PERSONS,
INTRODUCING BROKERS, FUND MANAGERS, COMMODITY TRADING ADVISORS OR POOL OPERATORS) CAN GUARANTEE PROFITS OR THE ABSENCE OF LOSSES. CUSTOMER AGREES TO PROMPTLY NOTIFY THE R.J. O'BRIEN COMPLIANCE DEPARTMENT IF ANY SUCH GUARANTEE IS SUGGESTED.

3. MARGINS

All checks and funds from Customer, to be credited to Customer's account(s), must be payable only to "R.J. O'Brien". Customer agrees at all times to maintain such margin in his account(s) as R.J. O'Brien may from time to time (at its sole discretion) require, and will meet all margin calls in a reasonable amount of time. Customer agrees that, if requested to do so, Customer will promptly wire-transfer such funds. Market conditions permitting, R.J. O'Brien agrees to make reasonable efforts to notify Customer of margin calls and/or deficiencies and to allow a reasonable period for Customer to provide funds.

FOR PURPOSES OF THIS AGREEMENT, A REASONABLE AMOUNT OF TIME SHALL BE DEEMED TO BE ONE (1) HOUR, OR LESS THAN ONE HOUR IF, IN R.J. O'BRIEN'S BUSINESS JUDGMENT, MARKET CONDITIONS WARRANT.

Customer further agrees that, notwithstanding anything in this Agreement to the contrary, in the event that the account (s) is under margined, has zero equity or is equity deficit at any time, or in the event that R.J. O'Brien is unable to contact Customer due to Customer's unavailability or due to a breakdown in electronic communications, R.J. O'Brien shall have the right to liquidate all or any part of Customer's positions through any means available, without prior notice to the Customer.

R.J. O'Brien may require margin in excess of that required by applicable law, regulation, exchange or clearinghouse minimums. Customer acknowledges that R.J. O'Brien has no obligation to establish uniform margin requirements among products or customers, that margins required by R.J. O'Brien may exceed the minimum margin requirements of the applicable exchange or clearinghouse, and that margin requirements may be increased or decreased from time to time in R.J. O'Brien's discretion, without advance notice to Customer. All deposits shall be deemed made only when cleared funds are actually received by R.J. O'Brien. If a check is not honored or paid by a bank upon presentment, R.J. O'Brien will immediately debit Customer's account for the amount of the returned check as well as any fees incurred.

Any failure by R.J. O'Brien to call for margin at any time shall not constitute a waiver of R.J. O'Brien's right to do so any time thereafter, nor shall such failure create any liability to the Customer. R.J. O'Brien shall not be liable to Customer for the loss or loss of use of any margin deposits option premiums, or other property, which is caused, directly or indirectly, by the failure or delay by any bank, trust company, exchange, clearing organization, other clearing broker or entity that is holding funds, securities, or other property to pay or deliver the same to R.J. O'Brien. R.J. O'Brien may, for any reason, require Customer to transfer its account (s) to another firm. If Customer does not transfer its positions promptly upon demand by R.J. O'Brien, R.J. O'Brien may liquidate the positions and Customer agrees to indemnify and hold R.J. O'Brien harmless from any and all losses resulting from such liquidation.

Customer acknowledges that R.J. O'Brien is hereby authorized, for its account and benefit, from time to time and without notice to Customer, either separately or with others, to lend, repledge, hypothecate or rehypothecate, either to itself or to others, any and all property (including but not limited to securities, commodities warehouse receipts or other negotiable instruments) held by Customer in any of its accounts and R.J. O'Brien shall not at any time be required to deliver to Customer such identical property but may fulfill its obligation by delivery of property of the same kind and amount.

Continued on Next Page.

9. Security Interest

Customer grants AACC a first lien and security interest in all monies, securities of any kind, open positions in Commodity Interests, documents representing title to commodities such as warehouse receipts and the commodities represented thereby and any other property of Customer (either individually or jointly with others) now or in the future held by AACC in the Account or otherwise in AACC's possession or control for any purpose, including safekeeping (collectively, the "Collateral"), to secure payment and discharge of all obligations of Customer to AACC or any affiliate of AACC, which Collateral is subject to the general lien of, and right of set-off by, AACC for any and all such obligations. Customer agrees to execute any and all documents including Uniform Commercial Code financing statements, as deemed necessary or appropriate by AACC to evidence or perfect its security interest in any Collateral. Customer has not granted and will not grant a security interest in the Collateral or it's Account (other than the security interest granted to AACC hereunder) to any other party without AACC's written consent.

Except as prohibited by Applicable Law, all Collateral now or hereafter held or carried by AACC for Customer may, from time to time, without notice to Customer, be pledged, hypothecated, loaned or invested by AACC to or with AACC or others, separately or with any other property. AACC shall not be required to retain in its possession for delivery a like amount of, or to pay interest or to account to Customer for any profits on, such property. All transactions for or on Customer's behalf may be included in a single Account whether or not such transactions are segregated on AACC's records into separate accounts, either severally or jointly with others.

10. Events of Default

The following events shall constitute an "Event of Default," as applicable: (a) Customer breaches, repudiates, or defaults in any way under this Agreement or any other agreement with AACC; (b) AACC, in its sole discretion, determines that it has sufficient grounds for insecurity with respect to Customer's performance of any obligation (including the obligation to deposit additional Collateral or margin) or Customer fails to provide assurance of performance of any obligation satisfactory to AACC; (c) Customer dies, becomes disabled, becomes incompetent or is subject to a rehabilitation, (d) Customer becomes subject to any bankruptcy, insolvency, receivership or similar action or proceeding; (e) Customer's Account is garnished or attached; (f) Customer takes any action to effect a dissolution, liquidation, reorganization, winding up of its affairs or any similar event; (g) AACC believes that any information or assertion provided or made to AACC is, or becomes, or will become, in any material way inaccurate or misleading; (h) Customer fails to deposit margin or make premium payments in accordance with the terms of this Agreement or to perform any of its other obligations hereunder, including those respecting delivery, exercise or settlement under any Commodity Interest held in the Account; or (i) AACC has reason to believe that any of the foregoing is likely to occur immediately.

11. Remedies Upon Default

Customer acknowledges and agrees that upon the occurrence of an Event of Default, or if AACC determines, in its sole discretion, that such action is necessary or advisable for AACC's own protection, AACC, may exercise any one or more of the following remedies, in addition to any other right or remedy available to it at law or in equity: (i) close out or hedge any open positions in Commodity Interests (in whole or in part) in Customer's Account in any manner AACC deems reasonable under the circumstances (including through use of exchange for related positions transactions in accordance with Exchange rules); (ii) apply any Collateral in the form of cash and liquidate or sell any or all non-cash Collateral and apply the proceeds thereof to offset Customer's obligations, (iii) borrow, lend, sell or buy any securities, commodities or other property for Customer's Account to cover or hedge any or all existing positions, (iv) place and/or establish spread transactions, (v) "roll" open positions forward, (vi) cancel any outstanding orders, commitments or obligations made by AACC on behalf of Customer; or (vii) terminate this Agreement, all without prior demand or notice to Customer. Any such sale, purchase, cancellation or other action may be made at AACC's sole discretion on the Exchange where such business is transacted, at public auction or by private sale, without advertising the same. Customer shall remain liable for the amount of

CUSTOMER AGREEMENT

This agreement ("Agreement") sets forth the terms and conditions under which MF Global Inc. and its affiliates ("we" or "us") (collectively "MF Global") will open and maintain one or more accounts (collectively, the "Account") in your name and on your behalf and otherwise transact business in cash commodities, commodity futures, security futures, options and forward contracts thereon, and interests therein (including, but not limited to, exchange-for-physical ("EFP"), exchange-for-swap ("EFS"), exchange-for-options ("EFO") and exchange-for-risk ("EFR") transactions), securities, foreign futures and options and foreign currencies (collectively, "Contracts") with you. If this Account has been introduced to us, all references to us in this Agreement shall include your broker, and your broker shall enjoy all benefits and rights hereunder.

1. APPLICABLE LAW; TRANSACTION FACILITIES

Each Account and all Contracts, transactions and agreements in respect of each Account shall be subject, as applicable, to: (i) the Commodity Exchange Act ("CEA") and all rules and interpretations of the Commodity Futures Trading Commission ("CFTC") and the National Futures Association ("NFA"); (ii) the constitution, by-laws, rules, regulations, policies, procedures, interpretations and customs of any applicable U.S. or non-U.S. board of trade, exchange, contract market, trading facility or execution facility, including, without limitation, an electronic trading system, facility or service, or clearing organization (each, a "Transaction Facility") or of any clearing firm or self-regulatory agency or organization; and (iii) any other laws, rules, interpretations, customs or usage of the trade applicable to your trading of Contracts. All such laws, by-laws, rules, regulations, policies, procedures, interpretations, customs and usage, as in force from time to time, are hereinafter collectively referred to as "Applicable Law."

This paragraph is solely for MF Global's protection and MF Global's failure to comply with any such statute, rule or regulation shall not be a breach of this agreement or otherwise a liability upon MF Global to Customer nor relieve Customer of any obligations under this Agreement.

2. MARGINS

You agree to maintain, without demand from us, such margin, cash or other acceptable collateral as we in our sole discretion may require from time to time, the amount of which may, in our sole discretion, exceed any amount that may be required by Applicable Law. Customer shall provide to and maintain with MF Global margin in such amounts and in such form as MF Global, in its sole discretion, from time to time may determine. Such margin requirements established by MF Global may exceed the margin required of MF Global by an exchange. MF Global may change margin requirements in its sole discretion at any time. If MF Global determines that additional margin is required, Customer agrees to deposit with MF Global such additional margin when and as required and demanded by MF Global, and will promptly meet all margin calls in such manner as MF Global shall designate in its sole discretion. Notwithstanding any demand for additional margin, MF Global at any time may proceed in accordance with Paragraph 4 below, and any failure to proceed shall not be deemed a waiver of any rights by MF Global. No previous margin shall establish any precedent. MF Global shall not be liable to Customer for the loss of any margin deposits which is the direct or indirect result of the bankruptcy, insolvency, liquidation, receivership, custodianship, or assignment for the benefit of creditors of any bank, another clearing broker, exchange, clearing organization, or similar entity.

3. SECURITY INTEREST AND LIEN

As security for the payment of all of your obligations and liabilities to us, we shall have a general lien and continuing perfected first security interest in, and lien upon, all property in which you have an interest held by or through us including, but not limited to, all Contracts, margin, collateral, performance bond, premium, funds, securities, currencies, credit balances, foreign exchange contracts, commercial paper, monies, any other property and all rights you may have against us (collectively, "Collateral"). In addition, in order to satisfy any outstanding liabilities or obligations you may have to us including, without limitation, any margin call, we may, at any time and without prior notice to you, sell, purchase, use, apply or transfer any of such Collateral interchangeably (including cash and fully paid securities). In the event of a breach or default under this Agreement or any other agreement you may have with us, we shall have all rights and remedies available to a secured creditor under Applicable Law, in addition to the rights and remedies provided herein.

4. LIQUIDATION OF ACCOUNTS

In the event of: (a) the death or judicial declaration of incompetency of Customer; (b) the filing of a petition in bankruptcy, or a petition for the appointment of a receiver, by or against Customer, or any one of the Customers if this is a joint account; (c) the filing of an attachment against any of the Customer's accounts carried by MF Global; (d) insufficient margin as determined by MF Global in its sole discretion, or MF Global's determination that any collateral deposited to protect one or more accounts of Customer is inadequate, regardless of current market quotations, to secure the account; or (e) any other circumstances or developments that MF Global deems to require action necessary for its protection, MF Global is hereby authorized, according to its judgment and in its sole discretion, to take one or more or any portion of the following actions: (1) satisfy any obligation Customer may have to MF Global, either directly or by way of guaranty or suretyship, out of any of Customer's funds or property in the custody or control of MF Global; (2) sell any or all futures Contracts, commodities, or securities held or carried for Customer or purchase any or all futures Contracts, commodities or securities held or carried as a short position for Customer; and (3) cancel any or all outstanding orders, Contracts, or any other commitments made on behalf of Customer. Any of the above actions may be taken without demand for margin or additional margin, without prior notice of sale or purchase or other notice or advertisement to Customer, his personal representatives, heirs, executors, administrators, legatees, or assigns, and regardless of whether the ownership interest shall be solely Customer's or held jointly with others. In liquidating Customer's long or short position, MF Global, in its sole discretion may sell or purchase in the same contract month or initiate new long or short positions in order to establish a spread or straddle which in MF Global's judgment may be necessary or advisable to protect existing positions in Customer's account, including by means of an EFP, EFS, EFO or EFR transaction (whether we act as broker for you or as principal opposite you in such EFP, EFS, EFO or EFR transactions). Any sales or purchases hereunder may be made according to MF Global judgment and at its discretion on any exchange or other market where such business is then usually transacted or at public auction or at private sale, and MF Global may purchase the whole or any part thereof free from any right of redemption. It is understood that, in all cases, a prior demand, call, or notice of the time and place of a sale or purchase shall not be considered a waiver of MF Global's right to sell or buy without demand or notice as herein provided. Customer at all times shall be liable for the payment of any debit balance upon demand by MF Global, and shall be liable for any deficiency remaining in Customer's account(s) in the event of the liquidation thereof in whole or in part by MF Global or by Customer. In addition,

CUSTOMER AGREEMENT (Continued)

MF Global shall have the right to set off and apply any amount owing from us to you against any indebtedness in your Account, whether matured or unmatured. In the event the proceeds realized pursuant to this authorization are insufficient for the payment of all liabilities of Customer due to MF Global, Customer promptly shall pay, upon demand, the deficit and all unpaid liabilities, together with interest thereon and all costs of collection including reasonable attorneys' fees. Customer agrees to pay all expenses, including attorneys' fees, incurred by MF Global to collect any debit balances in Customer's account or to defend any unsuccessful claim Customer may bring against MF Global.

5. FEES AND CHARGES

You understand and agree that we will charge commissions and other fees for clearing, execution, give-up, custody, storage, delivery, reports, quotes, processing, inactive Accounts, Account maintenance or any other service furnished to you, and you agree to pay such commissions, fees and interest on monies owed to us at our then-prevailing rates. You understand and agree further that such commissions, fees and interest rates may be changed from time to time. You also agree to pay any and all regulatory fees, any taxes imposed on transactions for your Account by any competent taxing authority and any other charges that may be imposed on such transactions. You will also be charged a fee for positions transferred to another broker. You understand that we may act as principal in certain transactions with you, including, but not limited to, cash market transactions, forward contracts, or EFP, EFS, EFO or EFR transactions.

6. FREE CREDIT BALANCES; TRANSFER ARRANGEMENTS

You authorize us to transfer funds, securities or other property to, between or among any of your futures Accounts and any other Account(s) held by us, when in our sole judgment a transfer of any excess funds in such Account(s) may be necessary to satisfy margin calls or to satisfy or reduce any debit balances or deficit in any such Account. We agree to confirm any such transfer to you in writing, and such confirmation shall be deemed reasonable notice. All such transfers shall be made in compliance with the CEA and the applicable regulations promulgated thereunder.

7. CONSENT TO LOAN OR PLEDGE

You hereby grant us the right, in accordance with Applicable Law, to borrow, pledge, repledge, transfer, hypothecate, rehypothecate, loan or invest any of the Collateral, including, without limitation, utilizing the Collateral to purchase or sell securities pursuant to repurchase agreements or reverse repurchase agreements with any party, in each case without notice to you, and we shall have no obligation to retain a like amount of similar Collateral in our possession and control.

8. STATEMENTS AND CONFIRMATIONS

You acknowledge that you are bound to the actual executions of transactions on the exchanges and understand that all reports of execution price quotations and other market information are subject to change and errors as well as delays in reporting. You agree that you rely upon such information at your own risk.

Confirmations of trades and any other similar notices, including but not limited to purchase and sale statements, sent to you shall be conclusive and binding unless you notify us to the contrary, (i) where a report is made orally, at the time delivered to Customer, or (ii) where a report or notice is in writing, prior to the opening of trading on the next day following delivery of the report on which the relevant Transaction Facility is open for business. Your account statement shall be conclusive and binding unless you notify us to the contrary immediately upon delivery to you. ANY OBJECTION TO A TRADE CONFIRMATION OR SIMILAR NOTICE OR A MONTHLY STATEMENT MUST BE MADE IN WRITING AND DIRECTED TO OUR COMPLIANCE DEPARTMENT ADDRESSED TO 440 SOUTH LASALLE STREET, 20TH FLOOR, CHICAGO, IL 60605 ATTENTION: COMPLIANCE 42, OR VIA FACSIMILE TRANSMITTED TO (312) 902-6169, WITHIN THE TIME PERIOD SET FORTH ABOVE. YOUR FAILURE TO PROVIDE SUCH TIMELY WRITTEN OBJECTION IN THE MANNER SPECIFIED SHALL CONSTITUTE RATIFICATION OF ALL ACTIONS TAKEN BY US OR OUR AGENTS.

9. INDEMNIFICATION; COSTS OF COLLECTION

You agree to indemnify and hold harmless each of us and our respective shareholders, directors, officers, employees, successors and assigns and agents from and against any liability, damage, cost or expense (including, without limitation, legal fees and expenses, amounts paid in settlement of any claims, interest and any fines or penalties imposed by any Transaction Facility, self-regulatory agency or organization or governmental agency) incurred as a result of your violation of any of your representations, agreements or obligations under this Agreement. You agree to pay and authorize us to charge you for any direct or indirect costs of collection, defense and enforcing any of our rights under this Agreement including, but not limited to, interest, legal fees, court costs and other expenses.

10. LIMITATION OF LIABILITY

You shall have no claim against us for any loss, damage, liability, cost, charge, expense, penalty, fine or tax caused directly or indirectly by: (a) any order transmitted by fax, electronic mail, instant messaging or other medium for execution which is accepted on a "not held" basis, that is you agree that we shall not be held liable for any failure regarding proper execution unless it is due to our fraudulent activity; (b) any Applicable Law, or any order of any court, governmental agency or other regulatory body; (c) suspension or termination of trading; (d) restrictions, exchange or market halts or rulings, acts of terrorism, riot, sovereign conduct or other acts of state, war or civil or labor disturbance; (e) any delays or inaccuracies in the transmission or reporting of orders or other information due to a breakdown or failure of any Transaction Facility or any other transmission or communication facilities for any reason; (f) failure or delay for any reason of any broker, bank, depository, Transaction Facility or custodian to fulfill its obligations or to pay in full any amounts owed to us or to you; (g) failure or delay by any entity which, consistent with Applicable Law, is holding customer segregated Collateral, to pay or deliver same to us; or (h) any other causes beyond our control.

In executing transactions on a Transaction Facility, we may use floor brokers (who may or may not be our employees or other agents of ours), but we will not be responsible to you for negligence or misconduct of an independent floor broker if, at the time the floor broker was selected, the floor broker was authorized to act as such under the rules of the relevant Transaction Facility and the appropriate regulatory agency. You also agree that we shall not be liable to you for any losses, costs, expenses or other damages sustained by you in the event of any failure or delay by any Transaction Facility, bank or other depository institution where any of your Collateral is maintained, or a failure or delay by any member, bank or agent of any of the foregoing to enforce its rules, to fulfill its obligations or to make any payment, for any reason whatsoever. You waive any claim, cause of action or right as against us, our directors, officers, employees or agents that may arise or occur as a result thereof. In no event will we be liable to you for any consequential, incidental or special damages under or relating to this Agreement. We will not be responsible to you in the event of error, failure, negligence or misconduct on the part of any intermediary, trading advisor, or other person acting on your behalf

CUSTOMER AGREEMENT (Continued)

and, without limitation, we have no obligation to investigate the facts surrounding any transaction in your account which is introduced by such Intermediary, trading advisor, or other person. In addition to any other agreement to indemnify us or any other party set forth in this Agreement or in any other agreement, you agree to indemnify us and hold us harmless from and against any and all liabilities, penalties, losses and expenses, including legal expenses and attorneys' fees, incurred by us as a result of any error, failure, negligence or misconduct on the part of any such Intermediary, trading advisor or other person acting on your behalf. We shall only be liable for actions or inactions by us which amount to gross negligence or willful misconduct.

11. TELEPHONE CONVERSATIONS

For the protection of both you and us, and as a way of correcting misunderstandings, you hereby authorize us, at our discretion and without prior notice to you, to monitor and/or record (with or without tone warning devices) any or all telephone conversations between you and any of our employees or agents. You waive any right you may have to object to the admissibility of such recording into evidence in any legal proceeding between us or in any other proceeding to which we are a party and our records are subpoenaed.

12. MAKING DELIVERY; LIQUIDATION INSTRUCTIONS

(a) You must give us liquidating instructions on open positions maturing in a current delivery month at least five (5) business days prior to the first notice day in the case of long positions and, in the case of short positions, at least five (5) business days prior to the last trading day. Alternatively, you must deliver to us sufficient funds to take delivery or the necessary delivery documents within the same periods described above. If we receive neither instructions, funds nor documents, we, without notice, may either liquidate your position or make or receive delivery on your behalf upon such terms and by such methods which we deem reasonable.

(b) If at any time you fail to deliver to us any property previously sold by us on your behalf or fail to deliver property, securities or financial instruments in compliance with futures contracts, or we shall deem it necessary (whether by reason of the requirements of any exchange, clearing house or otherwise to replace any securities, financial instruments, or other property previously delivered by us for your account with other property of like or equivalent kind or amount, you authorize us in our judgment to borrow or to buy any property necessary to make delivery thereof or to replace any such property previously delivered and to deliver the same to such other party to whom delivery is to be made. We may repay subsequently any borrowing thereof with property purchased or otherwise acquired for your Account. You shall pay us for any cost, loss and damage form the foregoing (including consequential damages, penalties and fines) which we may be required to incur or which we may sustain from our inability to borrow or buy any such property.

(c) Absent customer instructions to the contrary, expiring at or in-the-money long options will be exercised or abandoned pursuant to applicable Transaction Facility rules, and short options will be assigned futures positions pursuant to applicable Transaction Facility practices. You should not assume that an expiring out-of-the-money short option will be abandoned, as it is the buyer's right to exercise at any level. Notwithstanding the foregoing, we shall not have any obligation to exercise any long option contract unless you have furnished us with timely exercise instructions and sufficient initial margin with respect to each underlying contract. If we sell any property at your direction and you fail for any reasons to supply us with such property, we may (but shall not be obligated to) borrow or buy for you any property necessary to make such delivery. Under no circumstances shall we be obliged to make any payment or delivery to you except against prior receipt of payment or delivery by you of monies or other property requested by us. You shall be responsible for providing insurance coverage for any deliveries made or accepted by you. We do not provide any insurance coverage. If you do not provide insurance coverage, you agree to bear the risk of loss.

13. GOVERNING LAW; JURISDICTION AND VENUE; SERVICE OF PROCESS; LIMITATION ON ACTIONS; WAIVER OF JURY TRIAL

In order to induce us to accept this Agreement, and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, you hereby agree to the following:

(a) This Agreement is made, upon acceptance by us, in the State of Illinois, and shall be governed by, and the rights and liabilities of the parties, except as otherwise expressly stated herein, shall be determined in accordance with, the laws of the State of Illinois, without regard to any of its conflicts of laws principles or rules, by the laws of the United States and, where appropriate, by other Applicable Law.

(b) All actions or proceedings, whether initiated by you or us, with respect to any controversy arising out of or related to this Agreement, shall be litigated only in courts whose situs is in the State of Illinois. You hereby submit to the jurisdiction of the United States District Court of the Northern District of Illinois, Eastern Division, and any other court of competent jurisdiction whose situs is in Chicago, Illinois. If you bring any arbitration (including, but not limited to, NFA arbitration), administrative or reparations proceedings against us, you hereby authorize and direct such arbitrators, administrative law judges, or judgment officers to hold any such proceedings in Chicago, Illinois. You hereby waive any right you may have to transfer or to change the venue of any litigation you may bring against us, or to move that such litigation is brought in an inconvenient forum or that forum is improper.

(c) You agree to accept court service of process by registered or certified mail addressed to you at the address you provided in your Customer Account Application, or to such other addresses as you have supplied to us in writing, and such service shall constitute personal service of process, subject to the provisions of CFTC Regulation 15.05 with respect to non-United States persons.

(d) **You shall not bring any action, regardless of form, arising out of or relating to this agreement or transactions hereunder more than one year after the cause of action arose, provided, however, that any action brought under the provisions of Section 14 of the Commodity Exchange Act may be brought at any time within two years after the cause of action accrues.**

(e) **You hereby waive any right you may have to a trial by jury.**

14. WAIVER, ASSIGNMENT AND NOTICES

Neither our failure to insist at any time upon strict compliance with this Agreement or with any of the terms hereof nor any continued course of such conduct on our part shall constitute or be considered a waiver by us of any of our rights or privileges hereunder. We may assign this Agreement and your Account upon notice to you. Any

CUSTOMER AGREEMENT (Continued)

assignment of your rights and obligations hereunder or interest in any Collateral held by or through us without obtaining the prior written consent of an authorized representative of ours shall be null and void. Notices or other communications, including margin calls, delivered or mailed, including by facsimile or electronic transmission, to the address provided by you, shall, until we have received notice in writing of a different address, be deemed to have been personally delivered to you as of the date and time of transmission. Notices or other communications shall be provided to us in writing at the address set forth in Section 8 of this Agreement.

15. CLEARANCE ACCOUNTS; GIVE UPS

If your Account has been introduced to us by another broker, that broker is acting as your agent and that broker in this relationship is not an agent of or affiliated with us. You agree that your broker and its employees are third-party beneficiaries of this Agreement. Unless we receive from you prior written notice to the contrary, we may accept from such other broker, without any inquiry or investigation: (a) orders for the purchase or sale of Contracts, on margin or otherwise; and (b) any other instructions concerning your Account or the Collateral therein. **You understand and agree that by agreement with your broker we may pay a substantial portion of the brokerage commissions charged to your Account to your broker in consideration of introducing and servicing your Account. You further understand and agree that our role is limited to execution, clearing and bookkeeping for transactions made pursuant to instructions from you or your broker, and we generally will not inquire into the circumstances surrounding any transaction for your Account. We are not responsible for any acts or omissions of any independent introducing broker, including, but not limited to, sales practices, trading practices or recommendations. You agree to look solely to your independent introducing broker for redress of any loss or damage arising out of circumstances other than our own gross negligence or willful misconduct in the execution, clearance or bookkeeping of transactions for your Account.**

Absent a separate written agreement with you with respect to give-ups, we, in our discretion, may, but shall not be obligated to, accept from other brokers Contracts executed by such brokers for you and to be given up to us for clearance or carrying in an Account.

16. RESTRICTIONS

You understand that we may decline to accept any order, or restrict or prohibit trading in, or close, your Account for any reason whatsoever. **Without limiting the foregoing, we may, in our sole discretion, refuse to allow you to make or take delivery in your Account.** You acknowledge that we may, from time to time, place an Account in which there is no trading on inactive status and you agree to provide whatever information we may require upon your request to reactivate any such inactive Account.

17. CREDIT INFORMATION AND INVESTIGATION

You authorize us and, if applicable, your broker, to make and obtain reports concerning your identity, credit standing and business conduct.

18. LEGALLY BINDING

This Agreement shall be binding upon the parties hereto and their respective successors and assigns, and supersedes any prior agreements between the parties with respect to the subject matter hereof. You further agree that all purchases and sales shall be exclusively for your Account in accordance with your oral or written instructions or those of any party authorized to enter orders on your behalf. You hereby waive any and all defenses that any such instruction was not in writing as may be required by the statute of frauds or any similar law, rule or regulation.

19. AMENDMENT

You agree that we may modify the terms of this Agreement at any time upon notice to you, including notice by electronic means, provided you trade through us electronically or have agreed to receive confirmations and statements from us electronically. If you trade through us electronically or have agreed to receive confirmations and statements from us electronically, you further agree that any communications concerning your Accounts or services provided by us, including legal notices and agreements, may be sent to you via electronic mail. By continuing to trade through us, you signify your acceptance of the terms of such communication. If you do not accept the terms of such communication, you must notify us thereof in writing as provided in Section 8 above (including by electronic means, if applicable) and your Account may then be terminated, but you will still be liable thereafter to us for all remaining liabilities and obligations. Otherwise, this Agreement may not be waived or modified absent a written instrument signed by an authorized representative of ours. No oral agreements or instructions purporting to amend this Agreement will be recognized or enforceable.

20. SEVERABILITY

If any provision hereof is or should become or be deemed to be inconsistent with any present or future law, rule or regulation of any court, arbitral body, sovereign government or regulatory body having jurisdiction over the subject matter of this Agreement, such provision shall be deemed to be rescinded or modified in accordance with any such law, rule or regulation. In all other respects, this Agreement shall continue to remain in full force and effect.

21. ADDITIONAL RIGHTS AND REMEDIES

The rights and remedies granted herein to us are in addition to any other rights and remedies provided to us in any other agreement you may have with us, and you hereby appoint us as your agent to take any action necessary to perfect ourselves with respect to the security interest granted to us in this Agreement.

22. AUTHORITY

You represent that this Agreement has been duly authorized and executed by you, and that you have full power and authority to trade the Contracts. You further represent to us that, if you are employed in the financial services industry or by any Transaction Facility or self-regulatory agency or organization, you will obtain or have obtained all necessary consents to open this Account and will provide us with written proof of such consent.

23. CUSTOMER'S REPRESENTATIONS AND WARRANTIES

You represent to us that all information supplied by you in connection with the opening of your Account is accurate and complete and that we are legally entitled to rely on such information, and you agree to report immediately to us any material change in such information. In particular, you understand that all transactions effected for your Account are at your risk, and that you are solely liable therefor under all circumstances. You agree to inform us immediately if you cease to be willing or financially able to sustain such losses. You further represent, warrant and covenant to us that: (i) transactions entered into pursuant to this Agreement will not violate any Applicable Law, judgment, order or agreement to which you or your property is subject or by which you or your property are bound; (ii) except as disclosed in writing to us, you are acting solely as principal and not as agent for any other party and no other person or entity has any interest in the

CUSTOMER AGREEMENT (Continued)

Account; and (iii) you have reviewed the registration requirements of the CEA, CFTC and NFA relating to commodity pool operators and commodity trading advisors and have determined that you and any person that has trading authority or control over your Account are in compliance with such requirements. In entering into this Agreement and opening the Account, we are relying on your representations, warranties and covenants contained in this Agreement and you will immediately notify us of any material changes to the accuracy thereof.

24. CURRENCY EXCHANGE RISK; NON-U.S. FUNDS

You shall bear all risk and cost in respect of the conversion of currencies incident to transactions effected on behalf of you pursuant hereto. Unless otherwise specified in the reports sent to you with respect to your Contracts and Accounts, all margin deposits in connection with any Contracts, and any debits or credits to your Account(s), shall be stated in U.S. Dollars. By placing an order in a Contract settled in a particular currency (the "Contract Currency"), you agree to convert to the Contract Currency funds sufficient to meet the applicable margin requirement. Any conversions of currency shall be at a rate of exchange determined by us in our sole discretion based on prevailing money market rates of exchange for such currencies.

25. INFORMATION AND POSITIONS

Any information on the market or on matters incidental to the operation of any of your Accounts or the nature of any of the Contracts provided by us is solely incidental to the conduct of our business as an FCM. We make no representation as to the accuracy, completeness or reliability of any such information. We and our directors, officers and employees may take, hold or liquidate positions in, or provide such information to other customers with respect to, Contracts that are the subject of such information furnished by us to you, and such other positions and/or information may be inconsistent with the positions held by you or information given to you.

26. CFTC REGULATIONS

You acknowledge that you are aware that CFTC Regulation 1.35(a-2)(2) requires you to create, retain and produce upon the request of the CFTC, the United States Department of Justice and the applicable Transaction Facility, documentation of cash transactions underlying EFP, EFS, EFR or EFO transactions and, if you effect any such exchange of futures, you will comply with Regulation 1.35 (a-2)(2). If you are a non-United States person, you acknowledge that: (a) CFTC Regulation 15.05 designates us as the agent of foreign brokers, customers of foreign brokers, and foreign traders for certain purposes; and (b) CFTC Regulation 21.03 authorizes the CFTC to request, when unusual market circumstances exist, certain Account information from us as well as foreign brokers and traders, and you agree to provide such information upon such request.

27. ONLINE SERVICES; ELECTRONIC STATEMENTS; ELECTRONIC SIGNATURES

If we provide you with access to online brokerage service facilities, you must agree to the terms of the "Electronic Order Entry and Account Access Agreement," provided under separate cover, the terms and conditions of which are incorporated in this Agreement as if set forth herein.

28. CONSENT TO CROSS TRANSACTIONS

This consent is being provided in order to comply with exchange rules regarding cross trade procedures and the execution of trades in which a floor broker or brokerage firm may be directly or indirectly involved as a principal to a transaction on any exchange that, from time to time, adopts rules requiring customer consent for these transactions. Customer hereby consents that MF Global, its agents, or floor brokers handling MF Global orders, may, without prior notice, execute Customer's orders in which MF Global, its directors, officers, employees, agents, or the floor broker, may directly or indirectly, become the buyer to Customer's sell order or the seller to Customer's buy order, provided that such executions are made in accordance with exchange rules and any applicable provisions of the Commodity Exchange Act or regulations of the Commodity Futures Trading Commission. This consent shall be continuous and remain in effect until revoked in writing by Customer.

29. HEADINGS

The headings of the sections hereof are for descriptive purposes only and shall not modify or qualify any of the rights or obligations set forth in such sections, or in any way limit the applicability of or affect the meaning of any such provisions.

30. U.S. FUTURES EXCHANGE

You should be aware that the Company's parent company has an ownership interest in U.S. Futures Exchange and that the Company salespeople receive additional compensation for transactions executed on U.S. Futures Exchange. This additional compensation does not result in any charge to your account.

31. CUSTOMER ACKNOWLEDGMENTS; PLEASE INITIAL APPROPRIATE CLAUSE(S) BELOW:

(a) **RISK DISCLOSURE ACKNOWLEDGMENT:**
Customer hereby acknowledges that Customer has received the Disclosure Statement prescribed by the CFTC and furnished herewith. Customer understands that we are relying on Customer to familiarize itself with any disclosure in MF Global's booklet(s) that is or may become applicable to Customer's trading.

Initial   Initial   Initial   Initial

EXHIBIT B

ISRI Institute of Scrap Recycling Industries, Inc.

Scott J. Horne
Vice President &
General Counsel
Direct: +1 202 662 8513
ScottHorne@ISRI.org

December 4, 2012

Via Electronic Submission

David Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Comments on Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations. (RIN 3038-AD88, 77 Fed. Reg. 67866, November 14, 2012)

I. Introduction

The Institute of Scrap Recycling Industries (ISRI), on behalf of its members, respectfully submits these comments in response to the Notice of Proposed Rulemaking (the "Proposal") on Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations ("Enhanced Customer Protections"). ISRI's comments will be limited to (i) introducing the CFTC to the recycling industry and its significant role in commodity futures trading; (ii) discussing several critical issues that had not been addressed in the Proposal; and (iii) offering support for the Proposal for the Enhanced Customer Protections.

II. Institute of Scrap Recycling Industries

ISRI is a Washington, D.C. based trade association representing the scrap recycling industry. The industry is comprised of businesses engaged in the recycling of various commodities such as metals, plastics, glass, paper, rubber, textiles and electronics. Members of ISRI are involved in the processing, collection, trading and consuming of these commodities; for all intents and purposes the industry is the first link in the manufacturing chain. The scrap recycling industry produced approximately $100 Billion worth of commodities last year, which is equal to roughly 0.6 percent of GDP,[1] and is similar in size to the nation's forestry and fishing industries combined, nearly all of the nation's professional sports teams and the toy industry. In 2011, scrap recycling brokers and processors provided in excess of 459,000 jobs directly and indirectly.[2] Hedging metals' prices on commodity futures exchanges as a risk mitigation tool is a critical component of the financial and risk management activities conducted by scrap metal recyclers ("Metals Recyclers").

In addition to the impact on the domestic economy, the value of scrap exported by the scrap recycling industry in 2011 increased 32% to approach $40 Billion in export sales to 161 Countries.[3] Likewise, by value, scrap exports are one of the top 5 exports from the United States.[4] Many of the commodities traded by Metals Recyclers are also traded on commodity futures exchanges throughout the world. Hedging is widely used as a risk mitigation tool against metals' price volatility and serves to provide liquidity for the metals recycling industry. Within the metals producing, consuming and scrap industries, there is often a significant time lapse that occurs from the time metal is produced, bought, sold, shipped and consumed by an end-user. This is especially cogent because so many metals are shipped all over the world. Specifically, these commodities, such as copper, aluminum, steel, zinc, and tin, among others, are critical raw materials for both emerging markets as well as mature economies.

The collapse of MF Global exposed several systemic problems within the commodity futures trading industry and its oversight regime. According to the Staff Report Prepared for Rep. Randy Neugebauer, Chairman of the Subcommittee on Oversight & Investigations, Committee on Financial Services, and dated November 15, 2012, there is still in excess of $665 Million missing from Commodity Customers' accounts used for foreign trading, and likely in excess of $100 Million still missing from domestic accounts.[5] Many Metals Recyclers, as well as their suppliers, customers and consumers continue to represent a significant portion of the missing ***$765+ Million.*** It is uncertain whether any of the remaining missing funds will be recovered; and much is now

[1] In 2011, ISRI retained the independent consulting firm of John Dunham and Assoc. to perform an economic impact analysis of the scrap recycling industry on the U.S. economy. The statistics are based on the Economic Impact of the Scrap Recycling Industry in the United States (2011), produced for ISRI, by John Dunham and Associates, 2011.

[2] Scrap Recycling Industry Impact Methodology Summary, John Dunham and Associates, 2011.

[3] The United States Census Bureau and the United States International Trade Commission.

[4] The United States Census Bureau and the United States International Trade Commission.

[5] Staff Report Prepared for Rep. Randy Neugebauer, Chairman, Subcommittee on Oversight & Investigations, Committee on Financial Services, 112th Congress, November 15, 2012, p 73-74.

tied up overseas in legal battles stemming from the MF Global insolvency proceedings.

III. Hedging: Risk Mitigation in the Scrap Metal Recycling Industry

The hedging of metals prices by Metals Recyclers is "bona fide hedging" as defined under the Act[6] and is in contrast to the often erroneous use and application of the term hedging to other financial investment instruments and activities. Bona fide hedging is encouraged in many industries especially with respect to agriculture, and energy. However, the metals industry, and more specifically, the scrap metal recycling industry has not heretofore provided its input on the many issues exposed by the collapse of MF Global.

As mentioned above, Metals Recyclers use hedging on the commodity futures exchanges to mitigate the risk of exposure to metals' pricing volatility. In addition to hedging on domestic exchanges, Metals Recyclers hedge a considerable volume of aluminum and other nonferrous metals through U. S. based FCMs on the London Metal Exchange. As a practical matter, Metals Recyclers hedge to ensure, on some level, that the risk of the transaction is removed. Metals Recyclers maintain Segregated Accounts comprised of commodity exchange mandated margin requirements, and cash proceeds typically resulting from changes in trading positions and/or market fluctuations. The margin requirements mandated by the commodity exchange serve as collateral for a Metals Recycler's trading activities. Inherently, the Metals Recycler, who is hedging, seeks to reduce the risk of exposure to the market and is not assuming risk with respect to its collateral account.

IV. Critical Open Issues

In order for the markets to function efficiently, commodity customers must have confidence and trust in the market's financial safeguards. Specifically, in the absence of an FDIC or SIPC insurance type of regime, market participants must have a level of trust and confidence that there will not be a repeat of the circumstances involved in the collapse of MF Global and Peregrine. We applaud the CFTC for taking such strong measures in connection with the Enhanced Customer Protections and we fully support all of the proposals contained in RIN 3038-AD88, 77 Fed. Reg. 67866, November 14, 2012. However, there remain critical open issues of concern to Metals Recyclers that we would ask the CFTC to consider. The open issues stem from a combination of the scope of

[6] 7 U.S.C § 6a.

investments that FCMs are still permitted to make under the Act and the "permitted language" in Commodity Customer Agreements (the "Agreements") that grant FCMs unreasonably wide latitude to use and invest Customer Funds.

The language that is typically found in Agreements permitting an FCM to use Customer Funds, at the FCM's discretion (or whim), is buried deep within the Agreement. In order to open a commodity trading account with a particular FCM, a Commodity Customer must comply with such a clause. Below is a clause taken from an FCM's Agreement packet and two examples are attached as **Exhibit A**.

Except as prohibited by Applicable Law, all collateral now or hereafter held or carried by the clearing firm (CF) for customer may, from time to time, without notice to customer, be pledged, hypothecated, loaned or invested by CF to or with CF or others, separately or with any other property. CF shall not be required to retain in its possession for delivery a like amount of, or to pay interest or to account to customer for any profits on, such property. All transactions for or on customers behalf may be included in a single account whether or not such transactions are segregated on CF's records into separate accounts, either severally or jointly with others.[7]

This common clause skirts the spirit of the Act by granting wide latitude to the FCM to use Customer Funds, which the Commodity Customer is required to post for initial and variable margin. Allowing an FCM unfettered use of Customer Funds without a mechanism for such funds to be guaranteed or insured exposes those Customer Funds to risk of loss. The Enhanced Customer Protections do take a significant step towards reducing that risk and potentially providing an early warning mechanism for alerting the CFTC, Commodity Customers, and other oversight entities of the possibility that certain precarious issues may arise. Yet, the Regulations still prohibit parking margin in a security account that is otherwise insured by SIPC or a bank account that is otherwise insured by the FDIC.

Often, unknowingly, Commodity Customers acquiesce to these clauses which are buried deep within a forty or fifty page Agreement. Recognizing that a Commodity Customer must understand the terms of the Agreement, if a Commodity Customer wanted to modify or did not want to grant the FCM the rights as stated in that clause, Commodity Customers are powerless to negotiate

[7] Similar, if not exact, language exists on Commodity Customer Agreements from all FCMs, including MF Global.

changes -- the Agreements are nothing less than contracts of adhesion with regard to all except, perhaps, the very largest Customers.

Below are some examples of terms or modifications to Commodity Customer Agreements that were actually proposed and rejected:

1) Require FCMs to provide an alternative to granting them discretionary ability to pool and invest Customer Funds with the full understanding that transaction costs may increase.
2) Allow segregated margin funds for hedge accounts to be swept nightly into a securities account that is insurable by SIPC, and/or a commercial bank account insured by the FDIC.
3) Allow U.S. Treasury Notes, a permissible instrument to post as margin, to be held in the name of the Commodity Customer, and perhaps consider permitting a UCC filing.
4) Modify the scope of SIPC to include Customer funds insured up to a statutory limitation.

As noted above, several of the aforementioned concepts were presented to FCMs in the period following the collapse of MF Global when Commodity Customers were seeking to re-open accounts which were previously at MF Global and that had been transferred to another FCM. The response from the FCMs was that the terms of the Agreements were non-negotiable. Admittedly, some or all of the above suggestions would require FCMs to modify or forego their ability to speculate with Commodity Customers' Segregated Accounts holding margin requirements. However, from a Customer's point of view, these suggestions would go a long way towards leveling the playing field.

The FCMs appear to have no incentive to encourage them to negotiate certain terms of the Agreements with Commodity Customers. Nor are there any consequences set forth that would penalize FCMs for coercing Commodity Customers to agree to those conditions. Likewise, there are no regulations that provide Commodity Customers with rights to decline those conditions or negotiate more mutually agreeable terms. As discussed above, Commodity Customers have attempted to negotiate modifications to these Agreements; however, the responses received indicate that the Commodity Customers, if they want to continue to have an open and active account, must acquiesce.

Many Metals Recyclers who, as mentioned above, have ***hundreds of millions of dollars or more*** still tied up in both the domestic and the U.K. MF Global cases would clearly prefer that FCMs not have the ability to invest Customer Funds for the FCMs' benefit. The Customer Funds that are still unavailable from the MF Global case represent a significant level of working capital that may never be recovered. Although the Proposal seeks to create a higher level of trust and confidence that Customer Funds will not be put at risk by the FCMs, the Proposal contains no provisions that provide Commodity Customers with an option to "opt out" of granting FCMs access to their collateral.

We ask the CFTC to mandate that FCMs provide Commodity Customers the option to "opt out" of granting FCMs access to invest Customer Funds, yet permit those Commodity Customers to continue to actively trade. Alternatively, or in conjunction with an "opt out" provision we are asking the CFTC to consider further enhancements to customer protections that would provide FCMs with an incentive or some reasonable mechanism to negotiate and modify these terms of concern for those Commodity Customers that elect not to grant such wide latitude as is represented by the aforementioned Agreement clause. Examples of reasonable modifications are listed on the prior page.

V. "Enhanced Customer Protection Proposal" Comments

Within ISRI's governance regime, the Non-Ferrous Division (a group comprised of many businesses engaged in bona fide hedging) formed a sub-committee to study, review and comment on the Proposal from a Commodity Customer's perspective. We believe that the Enhanced Customer Protections, as proposed, provide a much higher level of customer protection. We recognize that many of the CFTC's requests for specific comments involve assessment of the projected costs that will be incurred by FCMs and we have elected not to comment on those requests. It is our position, from the Commodity Customers' perspective, that the Enhanced Customer Protections proposed by the CFTC and endorsed by Chairman Gensler[8] clearly serve to achieve their stated goals and on behalf of ISRI's members we support the Enhanced Customer Protections.

VI. Conclusion

As mentioned above, bona fide hedging employed as a risk mitigation tool protects Metals Recyclers against exposure to the volatility of metals pricing; similar in purpose and practice to hedging programs employed in the agriculture industry. Bona fide hedging programs are encouraged under the spirit of the Act.

[8] Summary of the Enhanced Customer Protections was compiled from the CFTC Release: PR6396-12 dated October 23, 2012, and Chairman Gensler's Statement of Support dated October 23, 2012.

Segregated Accounts were the mechanism used to hold initial and variable margin money required to be held on account as collateral with clearing firms. We ask the CFTC to give full and careful consideration to our requests concerning the critical open issues discussed in Section IV. We thank the CFTC for taking so many necessary steps to ensure that Commodity Customers' collateral held by FCMs is safe and secure. In order for the market to operate efficiently there must be confidence and mutual trust, neither of which exists right now as a lasting result of the collapse of MF Global and Peregrine.

Sincerely yours,

Scott J. Horne

Cc: Gary Gensler, Chairman, CFTC
Bart Chilton, Scott D. O'Malia, Jill E. Sommers, Mark Wetjen
Commissioners, CFTC
Gary Barnett, Director, Division of Swap Dealer and Intermediary
Oversight
Robin Wiener, President, ISRI
Jerry Simms, Chairman, ISRI
Doug Kramer, Chair – Elect, ISRI
Mark Lewon, Vice Chair, ISRI
Brian Shine, Secretary/Treasurer, ISRI
Matthew Heitmeier, Chair Non-Ferrous Division, ISRI. Director
NonFerrous Metals Marketing, Padnos
Joseph Pickard, Chief Economist/Director of Commodities, ISRI
Matthew Kripke, President, Kripke Enterprises.
Michael A. Eisner, President, Premier Metal Services, LLC
Mark A. Weintraub, In-house Counsel/Metals Trader, Premier Metal
Services, LLC.

R.J.O'Brien

ACCOUNT AGREEMENT

1. ACCOUNT STATUS

This Account Agreement ("Agreement") sets forth the terms and conditions upon which R.J. O'Brien & Associates, LLC ("R.J. O'Brien") will accept and maintain for the undersigned Customer one or more accounts and act as broker or dealer for Customer in the execution and clearance of orders for transactions (whether domestic or foreign) involving the purchase and sale of futures contracts; options on futures contracts; commodities and forward contracts, security futures contracts ("SSF"); option, spot and forward foreign exchange transactions; exchange for physicals ("EFPs"); and any other cash transaction or derivative, or any similar instruments which may be purchases, sold or cleared by or through an FCM (individually, a "Contract" and collectively, "Contracts"). Customer hereby represents that all responses made in connection with the Account Application and this Agreement are complete and correct, and that R.J. O'Brien will be informed of any material change in such data, including financial information.

If this account has been introduced to us, all references to us in this Agreement shall include your broker, and your broker shall enjoy all benefits and rights hereunder. Customer agrees and acknowledges that broker and R.J. O'Brien may share information with each other regarding or relating to Customer and/or Customer's account (s). Customer warrants to R.J. O'Brien that if Customer is an individual or if this is a joint account, Customer (s) is of legal age and of sound mind. Unless otherwise indicated in the Application, no one except the Customer (s) identified in the Account Application has an interest in the account (s). Customer agrees to permit verification of relevant information by R.J. O'Brien through third parties (including credit reporting entities). In any event, this Agreement and the account (s) permitted hereunder become effective only upon acceptance by an authorized representative of R.J. O'Brien at its principal office in Chicago, Illinois.

2. ACCOUNT RISKS

A.) TRADING IN CONTRACTS IS HIGHLY SPECULATIVE AND IN NO SENSE MAY BE CONSIDERED A CONSERVATIVE INVESTMENT;

B.) BECAUSE OF THE LOW MARGIN DEPOSITS NORMALLY UTILIZED AND THE VOLATILE PRICE MOVEMENTS WHICH CAN OCCUR IN THE MARKETS FOR CONTRACTS, THE POSSIBILITY OF RAPID AND SUBSTANTIAL LOSSES IS CONTINUALLY PRESENT;

C.) TRADING IN CONTRACTS IS APPROPRIATE ONLY FOR THOSE PERSONS FINANCIALLY ABLE TO WITHSTAND SUBSTANTIAL LOSSES, SOMETIMES GREATLY EXCEEDING THE VALUE OF THEIR MARGIN DEPOSITS; AND

D.) NO ONE (INCLUDING FUTURES COMMISSION MERCHANTS , ASSOCIATED PERSONS, INTRODUCING BROKERS, FUND MANAGERS, COMMODITY TRADING ADVISORS OR POOL OPERATORS) CAN GUARANTEE PROFITS OR THE ABSENCE OF LOSSES. CUSTOMER AGREES TO PROMPTLY NOTIFY THE R.J. O'BRIEN COMPLIANCE DEPARTMENT IF ANY SUCH GUARANTEE IS SUGGESTED.

3. MARGINS

All checks and funds from Customer, to be credited to Customer's account(s), must be payable only to "R.J. O'Brien". Customer agrees at all times to maintain such margin in his account(s) as R.J. O'Brien may from time to time (at its sole discretion) require, and will meet all margin calls in a reasonable amount of time. Customer agrees that, if requested to do so, Customer will promptly wire-transfer such funds. Market conditions permitting, R.J. O'Brien agrees to make reasonable efforts to notify Customer of margin calls and/or deficiencies and to allow a reasonable period for Customer to provide funds.

FOR PURPOSES OF THIS AGREEMENT, A REASONABLE AMOUNT OF TIME SHALL BE DEEMED TO BE ONE (1) HOUR, OR LESS THAN ONE HOUR IF, IN R.J. O'BRIEN'S BUSINESS JUDGMENT, MARKET CONDITIONS WARRANT.

Customer further agrees that, notwithstanding anything in this Agreement to the contrary, in the event that the account (s) is under margined, has zero equity or is equity deficit at any time, or in the event that R.J. O'Brien is unable to contact Customer due to Customer's unavailability or due to a breakdown in electronic communications, R.J. O'Brien shall have the right to liquidate all or any part of Customer's positions through any means available, without prior notice to the Customer.

R.J. O'Brien may require margin in excess of that required by applicable law, regulation, exchange or clearinghouse minimums. Customer acknowledges that R.J. O'Brien has no obligation to establish uniform margin requirements among products or customers, that margins required by R.J. O'Brien may exceed the minimum margin requirements of the applicable exchange or clearinghouse, and that margin requirements may be increased or decreased from time to time in R.J. O'Brien's discretion, without advance notice to Customer. All deposits shall be deemed made only when cleared funds are actually received by R.J. O'Brien. If a check is not honored or paid by a bank upon presentment, R.J. O'Brien will immediately debit Customer's account for the amount of the returned check as well as any fees incurred.

Any failure by R.J. O'Brien to call for margin at any time shall not constitute a waiver of R.J. O'Brien's right to do so any time thereafter, nor shall such failure create any liability to the Customer. R.J. O'Brien shall not be liable to Customer for the loss or loss of use of any margin deposits option premiums, or other property, which is caused, directly or indirectly, by the failure or delay by any bank, trust company, exchange, clearing organization, other clearing broker or entity that is holding funds, securities, or other property to pay or deliver the same to R.J. O'Brien. R.J. O'Brien may, for any reason, require Customer to transfer its account (s) to another firm. If Customer does not transfer its positions promptly upon demand by R.J. O'Brien, R.J. O'Brien may liquidate the positions and Customer agrees to indemnify and hold R.J. O'Brien harmless from any and all losses resulting from such liquidation.

Customer acknowledges that R.J. O'Brien is hereby authorized, for its account and benefit, from time to time and without notice to Customer, either separately or with others, to lend, repledge, hypothecate or rehypothecate, either to itself or to others, any and all property (including but not limited to securities, commodities warehouse receipts or other negotiable instruments) held by Customer in any of its accounts and R.J. O'Brien shall not at any time be required to deliver to Customer such identical property but may fulfill its obligation by delivery of property of the same kind and amount.

Continued on Next Page.

9. Security Interest

Customer grants AACC a first lien and security interest in all monies, securities of any kind, open positions in Commodity Interests, documents representing title to commodities such as warehouse receipts and the commodities represented thereby and any other property of Customer (either individually or jointly with others) now or in the future held by AACC in the Account or otherwise in AACC's possession or control for any purpose, including safekeeping (collectively, the "Collateral"), to secure payment and discharge of all obligations of Customer to AACC or any affiliate of AACC, which Collateral is subject to the general lien of, and right of set-off by, AACC for any and all such obligations. Customer agrees to execute any and all documents including Uniform Commercial Code financing statements, as deemed necessary or appropriate by AACC to evidence or perfect its security interest in any Collateral. Customer has not granted and will not grant a security interest in the Collateral or it's Account (other than the security interest granted to AACC hereunder) to any other party without AACC's written consent.

Except as prohibited by Applicable Law, all Collateral now or hereafter held or carried by AACC for Customer may, from time to time, without notice to Customer, be pledged, hypothecated, loaned or invested by AACC to or with AACC or others, separately or with any other property. AACC shall not be required to retain in its possession for delivery a like amount of, or to pay interest or to account to Customer for any profits on, such property. All transactions for or on Customer's behalf may be included in a single Account whether or not such transactions are segregated on AACC's records into separate accounts, either severally or jointly with others.

10. Events of Default

The following events shall constitute an "Event of Default," as applicable: (a) Customer breaches, repudiates, or defaults in any way under this Agreement or any other agreement with AACC; (b) AACC, in its sole discretion, determines that it has sufficient grounds for insecurity with respect to Customer's performance of any obligation (including the obligation to deposit additional Collateral or margin) or Customer fails to provide assurance of performance of any obligation satisfactory to AACC; (c) Customer dies, becomes disabled, becomes incompetent or is subject to a rehabilitation, (d) Customer becomes subject to any bankruptcy, insolvency, receivership or similar action or proceeding; (e) Customer's Account is garnished or attached; (f) Customer takes any action to effect a dissolution, liquidation, reorganization, winding up of its affairs or any similar event; (g) AACC believes that any information or assertion provided or made to AACC is, or becomes, or will become, in any material way inaccurate or misleading; (h) Customer fails to deposit margin or make premium payments in accordance with the terms of this Agreement or to perform any of its other obligations hereunder, including those respecting delivery, exercise or settlement under any Commodity Interest held in the Account; or (i) AACC has reason to believe that any of the foregoing is likely to occur immediately.

11. Remedies Upon Default

Customer acknowledges and agrees that upon the occurrence of an Event of Default, or if AACC determines, in its sole discretion, that such action is necessary or advisable for AACC's own protection, AACC, may exercise any one or more of the following remedies, in addition to any other right or remedy available to it at law or in equity: (i) close out or hedge any open positions in Commodity Interests (in whole or in part) in Customer's Account in any manner AACC deems reasonable under the circumstances (including through use of exchange for related positions transactions in accordance with Exchange rules); (ii) apply any Collateral in the form of cash and liquidate or sell any or all non-cash Collateral and apply the proceeds thereof to offset Customer's obligations, (iii) borrow, lend, sell or buy any securities, commodities or other property for Customer's Account to cover or hedge any or all existing positions, (iv) place and/or establish spread transactions, (v) "roll" open positions forward, (vi) cancel any outstanding orders, commitments or obligations made by AACC on behalf of Customer; or (vii) terminate this Agreement, all without prior demand or notice to Customer. Any such sale, purchase, cancellation or other action may be made at AACC's sole discretion on the Exchange where such business is transacted, at public auction or by private sale, without advertising the same. Customer shall remain liable for the amount of

EXHIBIT C

SPEECHES & TESTIMONY

"The End-User Bill of Rights"

Statement of Commissioner Bart Chilton

April 3, 2013

We are one week away from an important date in Dodd-Frank implementation: the April 10 compliance date for Dodd-Frank swap reporting rules for end-users. This date represents the first major compliance date for the end-user community, a class of market participants that includes many who have not been regulated by the CFTC until now.

As we move one step closer to the full implementation of Dodd-Frank, I'm reminded of another important transition, one from over 220 years ago, the transition of this great nation from a colonial monarchy to a national democracy. At the dawn of the United States of America, the founding fathers set out ten principles, the "Bill of Rights" that would bind the new national democratic government. Similarly, today I am setting out ten principles to guide the Commission as we move into a new, more transparent Dodd-Frank regulatory regime. I believe these principles best protect our consumers and end-users who help move our economy forward—and let's keep in mind that these end-users were not the cause of the financial crisis that lead to financial reform. In fact, end-users were among the many victims of the crisis and much of Dodd-Frank was drafted with their interests in mind.

The futures and swaps markets wouldn't exist without end-users. The primary public benefit of derivatives markets is that they provide end-users risk management opportunities that, in turn, allow them to more easily fund operations and investments and thereby generate economic growth. The ability of end-users to fund their operations is directly related to the prices paid by consumers and the overall well-being of our economy; so protecting the end-users is akin to protecting the every-day consumer. The End-User Bill of Rights therefore focuses on what I believe should be the inalienable rights of end-users:

1. Right to reasonable Dodd-Frank implementation. Dodd-Frank needs to be implemented and needs to be implemented quickly, but that does not mean it should be done so harshly. Back in December 2012, I supported the Commission providing good faith forbearance relief for swap dealers (SDs) and major swap participants (MSPs) until July 31, 2013 (under certain circumstances) when trying in earnest to come into compliance with new CFTC Dodd-Frank rules. Consistent with that six month forbearance relief, I will not approve an action against end-users seeking to comply with CFTC Dodd-Frank rules in good faith, provided they act in ways consistent with a good faith intention to comply, until after October 31, 2013.

2. Right to legal certainty. The Commission and the Commission staff need to provide the market as much legal certainty as possible as we move through a challenging implementation period. End-users and other market participants should have little doubt as to the status of their activities and the Commission and staff should respond thoughtfully and diligently to requests for legal certainty. When an answer isn't easy to provide, then the Commission or staff should be as transparent as possible with the public. The Commission or staff should strive to provide the market relief or clarity well in advance of a compliance date—last minute relief and clarification should be avoided. Finally, during this implementation of Dodd-Frank, I will not support an action against an end-user, exchange, or anyone else on an issue deserving clarity that is the subject of an outstanding request for interpretive guidance.

To provide a specific example of where the Commission could assist the end-user community with additional legal clarity, take the legal status of trade options. The Commission should tighten our guidance on commodity contracts with volumetric optionality, consistent with Commission precedent. At the same time, the Commission should focus on implementing Dodd-Frank for non-trade option swaps and broaden the trade option exemption in order to minimize any market disruptions in the trade options market. We should give end-users the opportunity to meet their statutory obligation to report trade options through an annual Form TO so that the Commission can monitor these markets for problems or evasion.

3. Right to compete in the markets. End-users should be able to hedge without getting mauled by cheetahs or crushed by Massive Passives. To protect end-users' right to compete in the markets, the Commission should start with two common sense rulemakings: First, we need high-frequency trader registration and conduct rules to prevent cheetahs from going feral. We should also provide the public market quality metrics designed to help end-users and other non-cheetahs from distinguishing between false cheetah liquidity and true liquidity. Second, we need caps on speculation so that the commodity markets return to their principal role as risk management markets for end-users. The commodity markets worked best when end-users were the predominant players. The Commission should move quickly on a new proposal on speculation limits by May 1.

4. Right to safe accounts. We need strong rules and rigorous auditing to ensure that futures commission merchants (FCMs) don't abuse their role as intermediaries while not imposing undue burdens on FCMs that provide end-users access to critical risk management markets (including a sensible compromise on residual interest). End-users should also have the right to choose between full segregation or to have their money at an FCM. If we require the availability of this option, the market will provide end-users better and more competitively-priced access to full segregation. Congress should also act to give end-users backstop protection through federally-mandated insurance.

5. Right to have confidence in the commodity markets. End-users should be confident that their intermediaries, FCMs and SDs in particular, are appropriately regulated and supervised. The Commission needs to establish rules that do this and ensure they are being enforced. The Commission needs bigger penalties to deter the abuses that threaten the health and stability of the markets. I have called for raising civil monetary penalty maximums to $10 million for entities and $1 million for individuals. The current $140,000 maximum civil monetary penalty is simply an inadequate deterrence for an agency tasked with, among other things, deterring manipulation and preventing systemic risk. Today's regulatory infractions can spawn tomorrow's financial meltdown and the Commission should be able to seek penalties to deter the malfeasance and negligence that can contribute to systemic problems.

6. Right to clear (or not to clear). The right to clear or not to clear should be protected for end-users. Central hedging units for non-financial end-users should be free to clear or not to clear on transactions that mitigate commercial risks for their corporate group. End-users that use inter-affiliate swaps to centralize and manage risk across a corporate group through a central hedging unit should be given the flexibility to clear or not to clear. End-users' inter-affiliate swaps should also be exempt from transaction-by-transaction reporting. The Commission should move quickly to provide relief from reporting requirements for inter-affiliate transactions for end-users.

7. Right to margin flexibility and reasonable capital rules. Under-collateralization has not been an end-user problem. Accordingly, I support the latest February 2013 IOSCO/Basel consultation that would exempt non-financial entities that are not systemically important from prescriptive margin requirements. The Commission also needs to come up with a sensible compromise on capital requirements for non-financial SDs. The Commission should encourage non-financial SDs to register. Non-financial SDs provide competition to financial SDs and their presence lets end-users hedge their risks on more competitive terms. On the one hand, Commission capital rules should ensure non-financial SDs have adequate capital to fall back on in the event of market or portfolio stresses. On the other hand, these rules should not put non-financial SDs at a competitive disadvantage.

8. Right to hedge. Speculative position limits should encourage and not unduly complicate prudent commercial risk management practices. Public power end-users using swaps to hedge commercial risk should have the same access to risk management markets as privately-owned utilities. This should be done preferably through regulatory relief.

9. Right to smart regulation. As we move through implementation, we are going to find smarter ways to accomplish regulatory policy goals. The Commission owes the end-user community a commitment that it will amend its rules when these smarter ways become apparent. For example, there may be more prudent ways to implement Part 46 historical swaps reporting for end-users that the Commission should consider. In the interim, the Commission should give end-users a six month reprieve, through October 2013, for historical swaps reporting requirements.

10. Right to be heard. SDs and MSPs are, by definition, big boys and girls who've seen the writing on the wall for years. As Commission registrants and as large financial conglomerates, they can go to the NFA or industry organizations like ISDA for guidance on how to comply with our rules. NFA and ISDA and similar organizations have experience orchestrating change on an industry-wide basis. Many end-users, on the other hand, are not used to having their swaps activity subject to CFTC regulation. During and after Dodd-Frank implementation we need a venue for end-users to air their concerns. I call for an End-User Advisory Committee (EUAC) with regularized meetings. End-users face an array of unique compliance challenges and legitimate business and regulatory concerns that warrant the Commission's focused attention.

Just like the Constitution is subject to amendment (some of the best amendments came almost eighty years after the first ratified draft), so is this document. I look forward to working with end-users, consumers, SDs, MSPs, FCMs, and others as we move through an exciting and challenging implementation period and invite their comments on this End-User Bill of Rights. If we do our jobs as regulators and implement Dodd-Frank quickly and reasonably, the markets will improve for the benefit of end-users and the American public. That was the goal of Congress and that continues to be my goal.

Last Updated: April 3, 2013

EXHIBIT D

American Metal Market

SEC ignored risks posed by copper ETF: Southwire

Mar 26, 2013 | 10:09 AM | *Andrea Hotter*

NEW YORK — The Securities and Exchange Commission (SEC) ignored warnings over the impact a physical copper exchange-traded fund (ETF) sponsored by JP Morgan Chase & Co. could have on lengthy queues at London Metal Exchange warehouses and on the incentives and premiums paid for metal, according to a court filing by a major U.S. copper consumer.

Carrollton, Ga.-based copper fabricator Southwire Co. said in documents filed with the U.S. Court of Appeals in Washington that the SEC failed to consider evidence it had provided showing the launch of a physical ETF could exacerbate a "bidding war" for copper among competing warehouse owners and end users.

The market is "already being severely constricted as a result of owners of LME warehouses paying huge premiums to metal producers to place copper that otherwise would be available for immediate delivery into warehouses with lengthy queues for physical delivery," the filing said.

Copper premiums in Antwerp jumped to as much as $100 per tonne last week, in line with incentives being offered by traders and warehouses to draw the metal into storage, according to *AMM* sister publication *Metal Bulletin*.

"Such practices by warehouse owners have led to vast amounts of such copper being stored in LME warehouses in New Orleans, Antwerp and Johor (Malaysia) where, when sold, it may not be available for physical delivery for months," the filing said. This is "a phenomenon which has effectively eliminated those warehouses as markets for copper available for immediate delivery, thus substantially shrinking the market for copper available for immediate delivery to whatever is delivered to a port where it could go on warrant in an LME warehouse or sold to an end user."

"The SEC not only failed to analyze the market as it exists today, but failed to analyze what the impact would be as authorized participants begin to vie with warehouse owners and end users for the limited supply of copper when it arrives in an LME port city such as New Orleans, Antwerp or Johor," the filing said. "The SEC looked only at existing premiums, concluded that they fluctuate, and failed completely to analyze what the premiums would be—and the cost to industrial end users and their customers—when shares of the (ETF) begin to be listed and traded."

Southwire made the comments in its continuing appeal of a decision by the U.S. regulator to allow JP Morgan's physical copper ETF (amm.com, Feb. 13).

The filing written by lawyer Robert Bernstein, a partner at New York law firm Eaton & Van Winkle, listed a number of factors Southwire alleges the SEC had failed to examine despite having been alerted to the company's concerns, including how much copper is currently being held by JP Morgan's LME-approved warehouse subsidiary Henry Bath, as well as the development of queues at those sites' warehouses.

The filing said the SEC had not examined the impact on copper consumers of the premiums they must now pay as a result of the warehouse queues, and how those premiums might change once the physical ETF is introduced.

JP Morgan argued that any copper taken out of LME warehouses for the ETF would not disrupt copper supplies because it would "remain available for immediate delivery to consumers and participants in the physical markets."

The bank plans to start small and build up. The product will be backed by less than 10,000 tonnes of copper when it initially launches and eventually reach an estimated 61,800 tonnes, although JP Morgan could seek to increase this if the product proves to be successful.

Southwire said in the filing that the ETF will create an "investor-financed squeeze" of the market, and together with the recently approved BlackRock Inc. physical copper ETF the products could remove 180,000 tonnes of copper from the market—nearly 40 percent of LME copper stocks (amm.com, Feb. 25).

Southwire has not yet formally appealed the SEC's decision to approve the BlackRock ETF, but the company's comments in the JP Morgan filing indicate it will do so and then move to consolidate the two appeals, a person familiar with the matter said.

The SEC did not identify or discuss alternatives to alleviate concerns over the ETF, the filing said, such as imposing "reasonable limits" on the amount of copper the ETF may hold or requiring that LME-grade copper held in the physical ETF be limited to metal that is on warrant, "which would at least keep copper acquired by the (ETF) subject to the LME's anti-squeeze rules."

Southwire complained that the SEC held a meeting with representatives of JP Morgan and its counsel to discuss the ETF Dec. 6 that it did not disclose until January, when the rule had already been approved (amm.com, Dec. 17). But on Dec. 5 the SEC formally denied a request for a similar meeting by Southwire and other industrial users who were part of a consortium opposed to the ETF before it was launched, the filing said.

The consortium included Southwire, AmRod Corp., Newark, N.J., Encore Wire Corp., McKinney, Texas, and London-based Luvata UK Ltd., along with metals-focused hedge fund RK Capital Management LLC, London. The other consortium members have dropped out of the appeal process, which is likely to be time consuming and costly.

377

EXHIBIT E

American Metal Market

In-warehouse copper premiums skyrocket

Apr 18, 2013 | 02:30 PM | Suzy Waite

NEW YORK — In-warehouse premiums for copper at London Metal Exchange-approved warehouses have skyrocketed after an April 10 wall slide at Kennecott Utah Copper Corp.'s Bingham Canyon Mine forced the company to declare force majeure.

Traders told AMM that in-warehouse duty unpaid premiums for material in Chicago, New Orleans and St. Louis locations were being quoted at around $50 per tonne this week and as high as $60 per tonne in St. Louis, up from between $30 and $45 per tonne in St. Louis previously and a far cry from the $5-to-$10-a-tonne range reported in Chicago and New Orleans prior to the mine collapse.

"Ten dollars (a tonne) really has no bearing on today's market, which is totally different from a week ago. What meaning does $10 have when you're taking 25,000 tonnes of production out of the system? Don't be surprised when (premiums) go from $10 (a tonne) when it's dead to $50 (a tonne) when it's not," one copper trader said of in-warehouse premiums.

A second trader agreed that $50 a tonne for copper in St. Louis warehouses was fair in today's market, although he added that he "personally would quote higher."

"Chicago would be $50 a tonne as well," the second trader said, adding that if he were to hear of any cheaper offers in the Midwest city, he plans to snap up the warrants himself.

A third copper trader agreed these much higher premiums to obtain LME copper warrants are not surprising given the Kennecott outage.

Kennecott informed customers in an April 15 letter that this month's copper cathode shipments would not be impacted as a result of its recent mine collapse but that May's refined copper shipments will be reduced. "Thereafter, we do not anticipate the ability to make further shipments for the foreseeable future," the company said at the time (amm.com, April 16).

As a result of the incident, London-based Rio Tinto Plc, which owns Kennecott, lowered its initial forecast of mined copper production to 540,000 tonnes this year from February's estimates of 665,000 tonnes and dropped its refined copper forecast to 205,000 tonnes from 305,000 tonnes previously (amm.com, April 16).

With a possible supply crimp on the horizon, more consumers may look to warehoused metal to meet their needs, hence putting upward pressure on in-warehouse premiums. Sources have predicted physical delivered copper premiums will also go up as buyers scramble to find material, with some already reporting higher quotes (amm.com, April 17).

Stocks in LME-approved warehouses in New Orleans have spiked to 176,200 tonnes as of April 16 from 75,775 tonnes on Jan. 2, with sources estimating that queues to get material from that city are as long as five months.

Stocks in Chicago and St. Louis have dipped from earlier this year, however, with Chicago holding 5,975 tonnes on April 16, down from 6,400 tonnes at the start of the year, and St. Louis stocks easing to 22,550 tonnes from 36,100 tonnes in January.

The rising cost of transferring ownership of copper warrants comes at a time when warehouses are also offering traders and producers attractive incentives to store material with them, which traders pegged at around $100 a tonne in some locations (amm.com, Oct. 12, 2012).

The fact that traders have taken these deals means their material is committed for some time to come however, a third trader said.
"My copper is all slated into New Orleans and it's all slated (to stay there) for X amount of time," the third trader said.

This means some will have to look to import new material, he said.

EXHIBIT F

American Metal Market

Copper mine outage sparks shift to scrap

Apr 18, 2013 | 06:05 PM | Barbara O'Donovan

NEW YORK — Domestic copper consumers that can use high-grade scrap are "scrambling" to find out about its availability in the wake of an outage at Kennecott Utah Copper's Bingham Canyon Mine.

"We've had some scrap buying. Those that can take scrap as well as copper cathode are looking to ramp up their buying," a scrap broker source told *AMM*.

Kennecott, a division of Rio Tinto Plc, declared *force majeure* earlier this week after an April 10 wall slide forced it to suspend mining at the Utah mine (amm.com, April 16).

Purchases so far have been limited as some take a wait-and-see stance, but sellers expect sales to spike as Kennecott's inventories run down.

"(Some) want to get in before the spreads get way out of whack," the scrap broker source said.

The higher demand combined with lower Comex copper prices served to reduce discounts on high-grade copper scrap.

The discount for brass mill No. 1 copper scrap has narrowed to 1 to 3 cents per pound below Comex from a 3- to 5-cent discount a week earlier, putting prices at $3.16 to $3.18 per pound based on a May-delivery Comex copper contract settlement price of $3.1875 per pound April 17.

The Comex price is down 6.7 percent from $3.418 per pound a week earlier as the market takes its lead from economic sentiment rather than supply and demand fundamentals, sources said.

The price decline has led market participants to predict more trades will take place at a premium to Comex following one unconfirmed sale by a broker last week at 2 cents above the July Comex price.

Kennecott customers aren't guaranteed deliveries after May, according to the *force majeure* notice. This will mean consumers will continue to look for alternative sources of feedstock.

Copper cathode inventories in London Metal Exchange-listed warehouses, while high, aren't a guaranteed source of material, market participants said (*amm.com, April 18*). Queues to get copper out of approved warehouses in New Orleans are at about five months, while consumers would have to wait more than a year to get their hands on material in Detroit warehouses, traders said.

"Even if warehouse stocks are high, most agree that it takes way too long to get metal out," a second broker said.

Continued scrap supply tightness helped narrow the discounts on other grades of copper scrap in the face of declining Comex copper prices and a slightly improved demand outlook.

The discount on refiners No. 1 copper scrap has declined to 9 to 11 cents per pound from 12 to 14 cents previously, putting prices at $3.08 to $3.10 per pound vs. $3.28 to $3.20 per pound April 10. The refiners No. 2 copper scrap discount moved to 27 to 29 cents per pound from 30 to 32 cents previously.

"(The discounts) are all coming in. Supply is pretty darned tight and demand is slightly better than it was," a third scrap broker said.

Brass ingot makers' copper scrap is following a similar trend, with the discount for bare bright material falling to 4 to 6 cents per pound from 6 to 8 cents previously, and the discount for brass ingot makers' No. 1 copper scrap at 13 to 15 cents per pound, down from 15 to 17 cents.

Ingot makers are having to compete with exporters for No. 2 copper scrap, the second broker said. As a result, the discount for No. 2 narrowed to 27 to 31 cents per pound from 30 to 34 cents previously.

Barbara O'Donovan

bodonovan@amm.com

RJO'Brien
Service is our trade • Since 1914

May 1, 2013

Hon. Debbie Stabenow
Chairwoman
United States Senate
Committee on Agriculture, Nutrition and Forestry
328A Russell Senate Office Building
Washington, DC 20510

The Honorable Thad Cochran
Ranking Republican Member
United States Senate
Committee on Agriculture, Nutrition and Forestry
328A Russell Senate Office Building
Washington, DC 20510

***Via Email:** cftcreauthorization@ag.senate.gov*

Dear Chairwoman Stabenow and Ranking Member Cochran:

R.J. O'Brien & Associates, LLC (RJO) thanks you for the opportunity to submit this letter is response to your request for issues to consider during the process of reauthorizing the Commodity Futures Trading Commission (CFTC). We appreciate your bi-partisan and open approach and would welcome the opportunity to participate in an ongoing dialogue with you during the course of this process. Founded in 1914, RJO is the oldest and largest independent futures brokerage and clearing firm in the United States. RJO provides hands-on order processing, research and assistance to our clients, many of which are farmers, ranchers and the other agricultural hedgers that are the foundation of the futures markets.

Customer Protection

Our greatest concern is ensuring that our clients have efficient and safe markets to allow them to manage their commercial and financial risks. We are an active member of the Futures Industry Association (FIA) and have been working with the entire industry to enhance protections for market participants. Indeed, new rules have already been put in place to provide customers with more information about the status of their funds and the financial condition of their futures commission merchants (FCMs). Regulators have also put in place systems to receive daily confirmations from banks holding customer funds and have implemented new rules that strengthen internal controls. Numerous additional regulations have been implemented by the industry's self-regulatory organizations that make it less likely that another MF Global or Peregrine Financial Group collapse can occur in the future.

The failures of MF Global and Peregrine Financial Group resulted in severe and unacceptable consequences for thousands of futures customers and the markets generally, and we agree that an ongoing review of current protections afforded to customers under the Commodity Exchange Act is warranted. And while we applaud the CFTC's recent additional efforts to provide increased customer and market protections, we urge the Committee and the CFTC to be mindful of the potential implications of new legislation and regulations on all market participants and to conduct full cost-benefit analysis when considering new laws and rulemaking.

In November 2012, the CFTC proposed rulemaking entitled "Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations." Along with over 100 others, we submitted comments on the CFTC's proposed rules. As detailed in our comment letter, we believe that many of the proposals would go a long way towards the goal of protecting customer funds. However, certain proposals regarding capital charges for outstanding margin calls and increased residual interest requirements for FCMs will dramatically raise the costs of hedging and investing in the futures markets and could result in limited market access for agricultural hedgers and smaller speculative investors. Furthermore, dramatically increased capital requirements for FCMs are likely to force small and mid-sized FCMs out of business, leaving the industry consolidated to bank-affiliated FCMs that have little interest in servicing the accounts of the farmers and ranchers that depend on futures markets to hedge their commercial risks and creating greater systemic risk, as was evidenced in the wake of the MF Global collapse.

In addressing customer protection, we urge the Committee to consider whether the CFTC should be required to fully assess and quantify the costs and benefits associated with the rules and orders they put forward rather than merely "considering" such costs and benefits. As the above discussion explains, without a thorough analysis, new rulemaking can produce unintended consequences that can be harmful to those that are most meant to be protected.

Regulation of FCMs

There are two significantly different main FCM models in the futures brokerage marketplace. The first is an FCM-only model, such as that adopted by RJO for nearly 100 years. Our main focus is providing hand-on customer service and market insight to individuals and smaller businesses, such as farmers and ranchers, to help them adequately hedge their commercial and financial risks or otherwise meet their investing goals. The second model is a dual-registrant BD/FCM that is often affiliated with an international investment bank. As mentioned above, the larger dually-registered broker-dealer/FCMs (BD/FCMs) generally have little interest in servicing smaller clients. These dual-registrant brokers predominately service large institutional investors, such as hedge funds, as well as facilitate their affiliates' proprietary trading activities. Yet BD/FCM's are not required to separately capitalize their futures businesses and securities businesses. Therefore, a BD/FCM often appears to be much better capitalized than any independent FCM when one compares standardized CFTC financial data. Furthermore, regulators utilize leverage formulas that ultimately penalize FCM-only firms for not engaging in proprietary trading or holding cash and requiring excess margin from customers. The leverage model does not account for the risks associated with a BD/FCM's securities business and proprietary trading activities, which some might argue was the reason for MF Global's downfall.

We therefore strongly urge the Committee to help ensure that the FCM regulatory framework adequately recognizes the differences between dual-registrant FCMs such as those described above and pure FCMs. The CFTC should be required to give proper consideration of the consequences to each of the two models during the rulemaking process. This procedure will help ensure that the characteristics and interests of smaller investors and the FCMs that serve them are properly accounted for in rulemaking.

Futures Markets Insurance

Various industry groups including the FIA, CME Group, NFA, and the Institute for Financial Markets have partnered to conduct an evaluation of the costs and benefits of various asset protection insurance proposals for the futures markets. RJO strongly supports the concept of an insurance model that is appropriate to the futures industry and asks the Committee to carefully consider the results of the study being conducted by these industry groups.

Modifications to the Bankruptcy Code

We believe that the Bankruptcy Code may require amendments to address shortcomings highlighted in the aftermath of MF Global and Peregrine Financial Group bankruptcies. RJO strongly supports the efforts being made by the industry and customers to identify potential changes to the Code that may provide better customer protections.

***

We greatly appreciate the Committee's attention to the comments and recommendations of the futures markets industry and its participants throughout the reauthorization process. We understand the complexity and importance of the Committee's task at hand and are grateful to have leaders that value the benefits of an open process.

Sincerely,

/s/ Gerald F. Corcoran

Gerald F. Corcoran
Chairman and CEO

sifma
Invested in America

May 1, 2013

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

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

Re: CFTC Reauthorization

Dear Chairwoman Stabenow and Ranking Member Cochran,

My name is Ken Bentsen and I am Acting President and CEO of the Securities Industry and Financial Markets Association ("SIFMA").[1] SIFMA appreciates the opportunity to provide input on the reauthorization of the Commodity Futures Trading Commission (the "CFTC"). Should Congress support Commodity Exchange Act ("CEA") reauthorization, we encourage consideration of the following issues, as discussed below.

As you know, the Dodd-Frank Act ("Dodd-Frank" or the "Act") created a new regulatory regime for derivative products commonly referred to as swaps. Dodd-Frank seeks to reduce systemic risk by mandating central clearing for standardized swaps through clearinghouses, capital requirements, and the collection of margin for uncleared swaps; to protect customers through business conduct requirements; and to promote transparency through reporting requirements and required trading of swaps on exchanges or swap execution facilities. To date, there have been significant reforms put in place that market participants have implemented. Late last year, firms engaged in significant swap dealing activities were required to register with the CFTC as swap dealers and became subject to reporting, recordkeeping and other requirements, many more of which will be phased in over time. Recently, the first swap

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

transactions were required to be cleared at central clearinghouses, in an effort to decrease systemic risk in the swap markets.

SIFMA supports the goals of Dodd-Frank with respect to most of Title VII. However, we remain concerned about how regulators, especially the CFTC, are interpreting and proposing to implement many of provisions. Indeed, in a few instances we also believe it is necessary that Congress amend the Act, as some provisions are duplicative and, at times, counterproductive. Poor implementation of Title VII has the potential to detrimentally limit the availability and increase the cost of derivatives, which are a valuable risk management tool for American businesses, including manufacturers and the agricultural industry.

We recognize the tremendous undertaking required by regulators in their efforts to implement derivatives reform. Throughout this process, SIFMA has frequently sought to engage with regulators in a constructive way.

As an overarching matter, it is our belief that the appropriate sequencing of Title VII rules and coordination between the various regulators responsible for them is critical to the successful implementation of the Dodd-Frank Act. In order to adapt to the new swap regulatory regime, our member firms are making dramatic changes to their business, operational, legal, and compliance systems. We continue to work closely with the CFTC on developing an appropriate implementation timeline to avoid a rushed process that would raise unnecessary complications and risk. The implementation of these new rules is not as simple as flipping a switch. They require a significant systems build, testing, training, and new documentation involving both dealers and customers. In addition, we encourage the regulators to harmonize their rules so that similar products will be subject to similar rules.[2] Conflicting or redundant rules, at best, add unnecessary cost and, at worst, increase risk.

The remainder of this letter will focus on a few specific issues that are under the jurisdiction of the CFTC, which could have a profound impact on the success of Title VII and its effects on the marketplace. In the event of CEA reauthorization, we urge that you consider them.

Cross-Border Impact of Dodd-Frank:

Though Title VII was signed into law two-and-a-half years ago, we still do not know which swaps activities will be subject to U.S. regulation and which will be subject to foreign

[2] SIFMA/ISDA Comments to CFTC on Proposed Schedule for Title VII Rulemaking (June 29, 2012), http://www.sifma.org/issues/item.aspx?id=8589939400; SIFMA Comments to SEC on the Sequencing of Compliance Dates for Security-Based Swap Final Rules (Aug. 13, 2012), http://www.sifma.org/issues/item.aspx?id=8589939893.

regulation. Section 722 of the Dodd-Frank Act limits the CFTC's jurisdiction over swap transactions outside of the United States to those that "have a direct and significant connection with activities in, or effect on, commerce of the United States" or are meant to evade Dodd-Frank. Section 772 limits the Securities and Exchange Commission's ("SEC") jurisdiction over security-based swap transactions outside of the United States to those meant to evade Dodd-Frank. The CFTC and SEC have not yet finalized rules clarifying their interpretation of these statutory provisions. The result has been significant uncertainty in the international marketplace and, due to the aggressive position being taken by the CFTC as described below, a reluctance of foreign market participants to trade with U.S. financial institutions until that uncertainty is resolved.

While the CFTC has proposed guidance on the cross-border impact of their swaps rules, this guidance inappropriately recasts the restriction that Congress placed on CFTC jurisdiction over swap transactions outside the United States into a grant of authority to regulate cross-border trades. The CFTC primarily does so with a very broad definition of "U.S. person," which it applies to persons with even a minimal jurisdictional nexus to the United States. In addition, the CFTC has released several differing interim and proposed definitions of "U.S. person" for varying purposes, resulting in a great deal of ambiguity and confusion for market participants. SIFMA supports a final definition of "U.S. person" that focuses on real, rather than nominal, connections to the United States and that is simple and objective, so a person can determine their status and the status of its counterparties.[3]

Further, the CFTC's proposed guidance has raised significant protests from foreign regulators, as it appears to contradict the history of comity and mutual recognition by seeking to impose a new form of substituted compliance on both a transactional and entity basis, jurisdiction by jurisdiction, in a manner that could result in overlapping or redundant application of rules at the expense of U.S. registered swap dealers.[4] In November, the CFTC held a meeting of its Global Markets Advisory Committee ("GMAC") to discuss cross-border issues related to over-the-counter ("OTC") derivatives reform implementation.[5] At this GMAC, several foreign regulators provided comments about the adverse impacts of the CFTC's proposed guidance.

---

[3] SIFMA Comments to CFTC Proposed Interpretive Guidance (August 27, 2013), *available at* http://www.sifma.org/issues/item.aspx?id=8589940053; SIFMA/TCH/FSR Comments to CFTC on Further Proposed Guidance (Feb. 6. 2013), *available at* http://www.sifma.org/issues/item.aspx?id=8589941955.

[4] Letters from: UK FSA (http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58432&SearchText=)
European Commission (http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58430&SearchText=)
French Ministry of Finance
(http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58417&SearchText=)

[5] http://www.cftc.gov/PressRoom/Events/opaevent_gmac110712

More recently a letter was sent to U.S. Treasury Secretary Jacob Lew in which senior representatives of several G20 members expressed concern over the lack of progress in developing workable cross-border rules as a part of global reforms for over-the-counter derivatives markets. The letter stated that a lack of coordination in the rulemaking process would result in a fragmentation of the derivatives markets into localized and less efficient structures, ultimately impairing the ability of businesses across the globe to manage risk. The letter concluded that this would "in turn dampen liquidity, investment and growth".[6]

Many other international financial regulatory and governing bodies also have sent letters in response to the CFTC's original proposed cross-border guidance.[7] A number of concerns over the proposal recur in these letters, including the process by which substituted compliance will be determined, the broad and unclear definition of "U.S. person," and legal barriers pertaining to compliance with the CFTC's reporting requirements. These commenters note that the guidance fails to spell out exactly how the CFTC will make substituted compliance determinations, thus creating uncertainty over whether and how duplicative and conflicting requirements under different regulatory regimes can be avoided. European regulators specifically pointed to potential conflicts with the European Market Infrastructure Regulation and the application of the CFTC Interpretative Guidance as currently proposed. Based on these concerns, the respondents recommended that comparability assessments be made on a country-by-country basis rather than a rule-by-rule basis.

Equally significant, the CFTC has issued its proposed cross-border release as "guidance" rather than through a formal rulemaking process subject to the Administrative Procedure Act. By doing so, the CFTC avoids the need to conduct a cost-benefit analysis, which is critical for ensuring that the CFTC appropriately weighs any costs imposed on market participants as a result of implementing an overly broad and complex "U.S. person" definition against its

[6] http://www.hm-treasury.gov.uk/d/letter_crossborder_otc_derivatives_reform_180413.pdf

[7] See comments from: Australian Securities and Investments Commission, Hong Kong Monetary Authority, Monetary Authority of Singapore Reserve Bank of Australia, Securities and Futures Commission (Hong Kong) (http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58444&SearchText) ; Comissao de Valores Mobiliaros (CVM Brazil) (http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58454&SearchText); European Securities and Markets Authority (ESMA) (http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58451&SearchText); Financial Services Authority Japan, Bank of Japan (http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58383&SearchText); Hong Kong Special Administrative Region (Secretary for Financial Services and the Treasury) (http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58448&SearchText); Swiss Financial Market Supervisory Authority (FINMA) (http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58317&SearchText).

perceived benefits.

The SEC proposed its cross-border rules on May 1, 2013. Rather than issuing cross-border interpretive guidance, the SEC is engaging in its full rulemaking process and is emphasizing the importance of providing sufficient opportunity for public comment on its proposed rules, including the associated cost-benefit analysis. While we have not yet had an opportunity to study the SEC cross-border release, we appreciate the SEC's efforts to address the cross-border issue holistically and to do so in a manner that is consistent with the Administrative Procedures Act.

SIFMA appreciates the comments of the Senate Agriculture Committee regarding the timely implementation of swaps regulations since the passage of the Dodd-Frank Act. Chairman Stabenow has applauded CFTC efforts in addressing complex issues and considerations of public comments in response, but expressed concern that "after two years of deliberation, it is time to get the rules written and to fully implement this strong reform bill."[8] We also appreciate the Committee's efforts in noting the importance of harmonizing rules across agencies and jurisdictions, as well as expressing concern about a potential overreach of the CFTC's cross-border guidance.

Last Congress, Congressmen Himes and Garrett introduced bipartisan legislation (H.R. 3283) that would provide clarity on this issue. The Himes-Garrett bill would permit non-U.S. swap dealers to comply with capital rules in their home jurisdiction that are comparable to U.S. capital rules and to adhere to Basel standards. The legislation also prevents the requirement that registered swap dealers post separate margins for each jurisdiction under which they are regulated. During the 112th Congress, the House Financial Services Committee acted to support this legislation by a vote of 41 to 18. SIFMA strongly supported this effort to clarify the jurisdiction of U.S. regulators.

In this Congress, Congressmen Garrett, Carney, Conaway and Scott have introduced bipartisan legislation, the Swaps Jurisdiction Certainty Act (H.R. 1256), that would harmonize the cross-border approaches by requiring the CFTC and SEC to jointly issue a rule related to the cross-border application of the Dodd Frank Act within 180 days, in accordance with the Administrative Procedures Act. This measure also ensures that firms in foreign countries with broadly equivalent swap regulatory regimes will not be subject to U.S. swap regulations. Finally, this legislation requires that the Commissions jointly provide a report to Congress if they determine that a foreign regulatory regime is not broadly equivalent to U.S. swap regulatory requirements. On March 20, 2013, H.R. 1256 was approved by voice vote by the

---

[8] http://www.ag.senate.gov/newsroom/press/release/chairwoman-stabenow-it-is-time-to-fully-implement-wall-street-reform

House Agriculture Committee to be recommended favorably to the House. SIFMA urges that Senate Agriculture Committee to include H.R. 1256 in the CEA reauthorization legislation.

The Swaps Push-Out Rule:

The Swaps Push-Out Rule, contained in Section 716 of the Dodd-Frank Act, was added to the Act at a late stage in the Senate and was not debated or considered in the House of Representatives. It would force banks to "push out" certain swap activities into separately capitalized affiliates or subsidiaries by providing that a bank that engages in such swap activity would forfeit its right to the Federal Reserve discount window or Federal Deposit Insurance Corporation ("FDIC") insurance.

The Swaps Push-Out Rule has been opposed by senior prudential regulators from the time it was first considered. Ben Bernanke, Chairman of the Federal Reserve, stated in a letter to Congress that "forcing these activities out of insured depository institutions would weaken both financial stability and strong prudential regulation of derivative activities."[9] Sheila Bair, former FDIC Chairwoman, said that "by concentrating the activity in an affiliate of the insured bank, we could end up with less and lower quality capital, less information and oversight for the FDIC, and potentially less support for the insured bank in a time of crisis" further adding that "one unintended outcome of this provision would be weakened, not strengthened, protection of the insured bank and the Deposit Insurance Fund."[10]

In addition to the increase in risk that would be caused by the Swaps Push-Out Rule, it would likely significantly increase the cost to banks of providing customers with swap products as banks would need to fragment related activities across different legal entities. As a result, U.S. corporate end-users and farmers will face higher prices for the instruments they use to hedge the risks of the items they produce. This increased fragmentation also would add unnecessary complexity to the organizational structure of banking organizations. Mark Zandi, Chief Economist at Moody's Analytics, stated in a letter to Congressman Scott Garrett that "Section 716 would create significant complications and counter the efforts to resolve [large financial] firms in an orderly manner."[11]

Bipartisan legislation, the Swaps Regulatory Improvement Act (S. 474), was introduced this Congress by Senators Hagan, Johanns, Toomey, and Warner to modify Section 716 of the Dodd-Frank Act by requiring only structured finance swaps based on asset-back securities to be

[9] Letter from Ben Bernanke, Federal Reserve Chairman, to Senator Christopher Dodd (May 13, 2010), *available at* http://blogs.wsj.com/economics/2010/05/13/bernanke-letter-to-lawmakers-on-swaps-spin-off/.
[10] Letter from Sheila Bair, FDIC Chairman, to Senators Christopher Dodd and Blanche Lincoln (Apr. 30, 2010), *available at* http://www.gpo.gov/fdsys/pkg/CREC-2010-05-04/pdf/CREC-2010-05-04-pt1-PgS3065-2.pdf#page=5.
[11] Letter from Mark Zandi, Chief Economist, Moody's Corporation, to Congressman Scott Garrett (Nov. 14, 2011).

pushed out of banks and would not apply 716 to equity or commodity swaps. The net effect of these changes would be to expand permissible swap activities within a bank, and to only exclude swaps based on asset-backed securities that do not meet qualifications to be established by regulation.[12]

In the House, Congressmen Hultgren introduced bipartisan legislation (H.R. 992) identical to S. 474, and on March 20, 2013, the House Agriculture Committee favorably approved this bill by a vote of 31 to 14. SIFMA urges the Senate Agriculture Committee to include S. 474/H.R. 992 in CEA reauthorization legislation.

Swap Execution Facilities:

As I noted above, the Dodd-Frank Act requires a subset of the most standardized swaps to be traded on an exchange or a new platform known as a "swap execution facility," commonly called a "SEF." Congress generally defined what constitutes a SEF but left further definition to the CFTC and SEC. To date, both the CFTC and SEC have proposed differing SEF definitions for the products under their respective jurisdictions, but neither Commission has adopted a final definition.

An appropriately flexible definition of "SEF" is critical for ensuring that the SEF trading requirement does not negatively impact liquidity in the swap markets. In truth, it remains unclear how the SEF trading requirement would impact the liquidity of instruments that have been traditionally transacted bilaterally. Understanding this reality, the SEC has proposed a rule that would permit SEFs to naturally evolve their execution mechanisms for swaps that are widely traded. These SEFs could be structured in many different ways, similar to how electronic trading platforms have evolved in the securities markets.

The CFTC has proposed a different rule that would require customers to either trade swaps on SEFs, as if they were traded on exchanges, or to solicit prices by issuing requests for quotes, generally known as "RFQs," from a minimum of five market participants for each swap subject to the SEF trading requirement. This differs from current market practice and could have a significant negative impact on the liquidity in the swap market. By signaling to the market the desire to purchase a swap, customers may be telegraphing important information that may impede best execution of their orders. While we appreciate the CFTC's goals of encouraging competition among dealers to decrease the price of swaps, the reality is that this practice will do just the opposite and drive up the cost of transactions, ultimately harming the

[12] In addition, the bill would fix a drafting error acknowledged by the Swaps Push-Out Rule's authors, under which the limited exceptions to the rule that apply to insured depositing institutions appear not to include U.S. uninsured branches or agencies of foreign banks.

corporations and other swaps users this rule aims to protect.

Congressmen Garrett, Hurt, Meeks, and Moore recently sent a letter to CFTC Chairman Gensler expressing concern about the minimum requirement of obtaining fives RFQs and noted that an arbitrary requirement for a minimum may undermine the goal of enhancing transparency in the marketplace and would "result in deleterious effects on the marketplace, while not adding any measurable transparency benefit."[13]

Last Congress, the House Financial Services Committee supported, by voice vote, legislation that would require the CFTC and the SEC to adopt SEF rules that allow the swaps markets to naturally evolve to the best form of execution (H.R. 2586). H.R. 2586 would not require a minimum number of participants to receive or respond to quote requests and would prevent regulators from requiring SEFs to display quotes for any period of time. Finally, this bill would prevent regulators from limiting the means by which these contracts should be executed and ensuring that the final regulation does not require trading systems to interact with each other. SIFMA urges the Senate Agriculture Committee to support similar legislation in CEA reauthorization.

Inter-Affiliate Swaps:

The Dodd-Frank Act is effectively silent on the application of swap rules to swaps entered into between affiliates. Such inter-affiliate swaps provide important benefits to corporate groups by enabling centralized management of market, liquidity, capital and other risks inherent in their businesses and allowing these groups to realize hedging efficiencies. Since the swaps are between affiliates, rather than with external counterparties, they pose no systemic risk and, therefore, there are no significant gains to be achieved by requiring them to be cleared or subjecting them to margin posting requirements. In addition, these swaps are not market transactions and, as a result, requiring market participants to report them or trade them on an exchange or swap execution facility provides no transparency benefits to the market—if anything, it would introduce unnecessary information that would make Dodd-Frank's transparency rules less helpful.

Recognizing the distinct characteristics of these transactions, on April 1, 2013 the CFTC published its final rule providing an exemption from clearing obligations for certain inter-affiliate swaps, including inter-affiliate swaps involving insured depository institutions.[14] However, the rule is quite complex and onerous, imposing significant conditions and

[13] Letter to CFTC Chairman Gary Gensler from Reps. Garrett, Hurt, Meeks, and Moore dated April 5, 2013

[14] http://www.gpo.gov/fdsys/pkg/FR-2013-04-11/pdf/2013-07970.pdf.

qualifications on affiliates that limit the usefulness of the exemption. Problematically, in order to utilize this exemption, market participants may be required to clear swaps between "non-U.S. persons" that otherwise would not be subject to U.S. jurisdiction – effectively allowing the CFTC to expand its jurisdictional reach far beyond that contemplated by the Dodd-Frank Act.

During the 112th Congress, the House of Representatives voted 357 to 36 in support of legislation (H.R. 2779) that would exempt inter-affiliate trades from certain Title VII requirements due to the important role such transactions play in firms' risk management procedures and the negative impact the full scope of Title VII regulation would have if applied to them. In this Congress, Congressmen Stivers and Moore introduced H.R. 677, the Inter-Affiliate Swap Clarification Act, which would exempt certain inter-affiliate transactions from the margin, clearing, and reporting requirements under Title VII. On March 20, 2013, H.R. 677 was approved by voice vote by the House Agriculture Committee to be recommended favorably to the House. SIFMA urges the Senate Agriculture Committee to include H.R. 677 in CEA reauthorization legislation.

Basel III:

Implementation of the Basel III capital standards accord is an area of great interest and concern for our members and the financial services industry as a whole. The industry is in strong support of efforts to promote consistent international standards.

The European Union is currently finalizing its implementation of Basel III, known as Capital Requirements Directive IV (CRD IV). As drafted, CRD IV would exempt EU supervised swap dealers from certain Basel III capital mandates, specifically the credit valuation adjustment (CVA), when doing business with non-financial end-users, pension funds and sovereign entities. Market participants globally have raised legitimate concerns about the CVA calibration, and we believe the Basel Committee should revise the calibration. The Basel Committee should also take account of the effects on corporate end-users of parallel regulation requiring central clearing or margin for uncleared OTC derivatives. Recently, Canada announced a delay of the CVA (despite finalizing the rest of Basel III) given uncertainty around the provision's global implementation and effects on non-financial entities. Notwithstanding these real problems with CVA, different application by different jurisdictions will result in unlevel treatment and fragmentation in conflict with the G20 principles.

Accordingly, Congressman Fincher introduced the Financial Competitive Act, (H.R. 1341), that would direct the Financial Stability Oversight Council (FSOC) to examine differences in the implementation of derivatives capital requirements and the CVA. Further, the bill would require FSOC to assess the effects on the US financial system and to make recommendations to minimize any negative impact on US financial firms and end-users. This legislation has been referred to the House Financial Services and Agriculture Committees. SIFMA urges the Senate Agriculture Committee to include H.R. 1341 in CEA reauthorization legislation.

Margin Requirements:

The CFTC is currently considering rulemaking detailing margin requirements for uncleared swap transactions. The Commission originally proposed rules during the summer of 2011, and later reopened its comment period in light of consultative guidance from the Basel Committee on Banking Supervision ("BCBS") and International Organization of Securities Commissions ("IOSCO") released during the summer of 2012 (a second consultation was released in February 2013). Market participants have expressed great concern over the various regulatory proposals regarding initial margin requirements, especially those which would require the mandatory exchange of two-way initial margin subject to restrictions on re-hypothecation and re-use. SIFMA has urged regulators to utilize daily variation margin requirements to meet G20 efforts aimed at reducing systemic risk and increasing market stability, while avoiding the imposition of onerous mandatory initial margin requirements, which would drain liquidity and have negative pro-cyclical impacts on markets during times of stress.[15] SIFMA urges the Senate Agriculture Committee to consider SIFMA's comments regarding proposed margin requirements for uncleared swaps in the CEA reauthorization legislation.

Thank you for giving me this opportunity to explain our views related to several important measures to be considered by the Senate Committee on Agriculture.

Kenneth E. Bentsen, Jr.
Acting President and CEO
Securities Industry and Financial Markets Association

[15] SIFMA has responded to various regulatory proposals on initial margin requirements. These include responses to the CFTC's re-opened comment period on proposed rules on margin for uncleared swaps, submitted Sept. 14, 2012; http://www.sifma.org/issues/item.aspx?id=8589940303), and to the first and second BCBS/IOSCO consultative documents on margin requirements for non-centrally cleared derivatives, submitted Sept. 28, 2012 (http://www.sifma.org/issues/item.aspx?id=8589940507) and March 15, 2013 (https://www.sifma.org/issues/item.aspx?id=8589942551), respectively. SIFMA has also provided comments in response to SEC (http://www.sifma.org/issues/item.aspx?id=8589942116) and U.S. Prudential Regulator proposals (http://www.sifma.org/issues/item.aspx?id=8589941054) on margin requirements for uncleared swaps.

SOUTHWEST AIRLINES CO.

Ron Ricks
Executive Vice President
Chief Legal and Regulatory Officer

P.O. Box 36611
Dallas, TX 75235-1611
(214) 792-4174

June 1, 2013

The Honorable Debbie Stabenow
Chair, Committee on Agriculture
United States Senate
Washington, DC 20510

The Honorable Thad Cochran
Ranking Member, Committee on Agriculture
United States Senate
Washington, DC 20510

Dear Chairwoman Stabenow and Senator Cochran:

Last month, I met with Committee staff to discuss the Commodity Futures Trading Commission (CFTC's) "Real Time Reporting Rule" and its impact to an end-user like Southwest Airlines (Southwest). As a follow-up to that meeting, please see the attached memorandum.

By way of background, Southwest is the ONLY major U.S. airline with a national route network that has not done one or more of the following:

1. Gone out of business;
2. Gone bankrupt and reorganized;
3. Laid off Employees;
4. Reduced workers' wages and benefits; or,
5. Reduced flights and seat capacity as a result of financial failure.

Southwest is the ONLY major U.S. airline with a national route network that has:

1. Been profitable for 42 consecutive years;
2. Paid shareholders dividends for 146 consecutive calendar quarters;
3. Industry leading pay and benefits for its largely unionized work force;
4. Been recognized perennially by Fortune Magazine as one of the most admired companies in the world; and,
5. Been recognized repeatedly as one of the best places to work in America.

Southwest is distinct from the rest of the airline industry in one other material respect: it is ***the only airline in the U.S. that has consistently, over decades, successfully hedged its fuel costs through legitimate end-user derivatives purchased in the futures markets***. That is a good thing. Southwest spends 35% of every dollar received from Customers on jet fuel—about $6 billion annually. Failure to manage fuel costs is the essence of risk in the airline business. Navigating around risk has allowed Southwest Airlines to avoid the fateful ends other airlines, their Employees, and the communities they served have suffered.

Southwest's ability to manage that risk is in jeopardy due to a recent rule enacted by the CFTC. That rule, known as the "Real Time Reporting Rule," is discussed fully in the attached memorandum. We do not believe the negative consequences of this rule were intended by the Congress, or for that matter, by the CFTC. We would urge your consideration of this issue and respectfully request your assistance and cooperation in rectifying this inequity.

Sincerely,

Ron Ricks

Ron Ricks

CFTC's Real-Time Reporting Rule
Impediment to Commercial End-Users in Illiquid Markets
June 2013

Issue Summary

The Commodity Futures Trading Commission's ("CFTC's") "Real-Time Public Reporting of Swap Transaction Data" rule sets forth the time delay before swap trade data is publicly disseminated. Southwest Airlines ("Southwest") supports the goal of transparency and regulators' monitoring for systemic risk and recognizes that under the rule, commercial end-users (or "non-dealers") like ourselves trading with other entities not registered as swap dealers or major swap participants have a longer time before we have to publicly report our trade data. Swap dealers and major swap participants (generally referred to as "dealers") have a much shorter time limit by which to report trade data after execution. However, the rule requires trades between a non-dealer and a dealer be reported within the dealer's shorter time limit. Given that the vast majority of bilateral trades entered into by commercial end-users are transacted with a dealer, this means nearly all commercial end-user trades are reported to the market on the accelerated time limit.

The dealer time delays may be sufficient for liquid markets, but they are not sufficient for illiquid markets and timeframes. Southwest commonly enters into transactions many months or years in advance of needing the physical product. Few market participants trade that far out, so the contracts are highly illiquid, even in contracts which may be liquid in the front months such as crude oil. When a dealer has to report such illiquid trades to the market quickly, the dealer is less likely to be able to lay off the risk of that trade in the prescribed time. If the dealer is still holding a large amount of the risk when the trade is shown to the public, the dealer can be front-run and, as a result, take a loss on the trade. That increased risk to the dealer will cause the dealer to charge their counterparty a premium to do the trade, if they are willing to execute the trade at all. This increased cost and possible inability to trade out the curve will cripple Southwest's ability to effectively manage risk, which is a critical component of our business.

While the CFTC's rule has only been in effect for a couple of months, Southwest is already seeing changes in market behavior and swap pricing. A recent trade cost Southwest an additional 35 basis points in spread. Applying an additional 35 basis points in cost to the typical volumes traded by Southwest – in illiquid areas of the crude curve and in illiquid products such as jet fuel – will add roughly $60 million in annual additional costs. Following the rule's implementation, Southwest immediately began receiving phone calls from dealer counterparties after reviewing the reported swap trades with statements like, "I see you just did a trade in 2017." That is anecdotal evidence that our positions, although not listed by name, are readily identifiable to the market given our unique strategy and large positions, which stand out in illiquid months on the curve.

<u>Proposed Legislative Solution</u>

Section 2(a)(13) of the Commodity Exchange Act (7 U.S.C. 2(a)(13)) is amended—

a. *In subsection (C), by striking ""General Rule.—The" and inserting "Except as provided in subparagraph (D), the";*
b. *Redesignating subparagraphs (D) through (G) as subparagraphs (E) through (H), respectively; and*
c. *Inserting the following new subparagraph:*

"(D) Public Reporting Requirements for Swap Transactions in Illiquid Markets.— Notwithstanding subparagraph (C) –

"(i) The Commission is required to provide by rule for the public reporting of swap transactions, including price and volume data, in illiquid markets that are entered into by a non-financial entity that is hedging or mitigating commercial risk in accordance with section 2(h)(7)(A)(ii).

"(ii) The Commission shall ensure that such swap transaction information is available to the public no sooner than 30 days after the swap transaction has been executed or at such later date as the Commission determines appropriate to protect the identity of participants and positions in illiquid markets and to prevent the elimination or reduction of market liquidity.

"(iii) For purposes of this subparagraph, the term "illiquid markets" means any market in which there is relatively little volume and infrequent trading in swaps."

<u>Proposed Report Language</u>

Real-time public reporting of swap transactions may ultimately lead to more efficient prices for commercial end-users, although that remains to be seen. However, based on the fact that liquidity diminishes further out in time, there is a point where the benefits derived from public reporting do not outweigh the detriment to those who are trading illiquid contracts as the market participants become easier to identify, ultimately allowing other participants to take advantage of their market position. The Committee believes that in Brent crude oil swap and swaption contracts, the liquidity profile changes significantly twenty-four months out from the front month contract. In complying with this section, the Commission shall create a standard for reporting all swap asset classes based off the liquidity point in any particular swap or swaption curve that is consistent with the twenty-four month point on the Brent crude oil swap curve.

Intent of Congress

Below is the relevant statutory provision from the Dodd-Frank Act (P.L. 111-203) requiring real-time reporting of swap data:

From Dodd-Frank, SEC. 727. PUBLIC REPORTING OF SWAP TRANSACTION DATA.

"(E) RULEMAKING REQUIRED.—With respect to the rule providing for the public availability of transaction and pricing data for swaps described in clauses (i) and (ii) of subparagraph (C), the rule promulgated by the Commission shall contain provisions—

"(i) to ensure such information does not identify the participants;

"(ii) to specify the criteria for determining what constitutes a large notional swap transaction (block trade) for particular markets and contracts;

"(iii) to specify the appropriate time delay for reporting large notional swap transactions (block trades) to the public; and

"(iv) that take into account whether the public disclosure will materially reduce market liquidity."

SUTHERLAND

SUTHERLAND ASBILL & BRENNAN LLP
1275 Pennsylvania Avenue, NW
Washington, DC 20004-2415
202.383.0100 Fax 202.637.3593
www.sutherland.com

June 27, 2013

The Honorable Debbie Stabenow, Chairwoman
The Honorable Thad Cochran, Ranking Member
U.S. Senate Committee on Agriculture, Nutrition & Forestry
328A Russell Senate Office Building
Washington, DC 20510

VIA ELECTRONIC MAIL

Re: *CFTC Reauthorization*

Dear Chairwoman Stabenow and Ranking Member Cochran:

I. INTRODUCTION.

On behalf of The Commercial Energy Working Group (the "**Working Group**"), Sutherland Asbill & Brennan LLP hereby submits these high-level comments in response to the United States Senate Committee on Agriculture, Nutrition & Forestry's request for comment on the Commodity Futures Trading Commission ("**CFTC**") Reauthorization. The Working Group has identified the following issues as the primary areas where Congress can improve the derivatives regulation infrastructure set forth in the Commodity Exchange Act ("**CEA**") to better protect the needs of commercial firms. Members of the Working Group met with your staffs on May 9, 2013 to discuss these issues. This letter provides an outline of the topics discussed during those meetings. The Working Group appreciates the opportunity to provide the comments set forth herein and respectfully requests the Committee's consideration of such comments.

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are energy producers, marketers, and utilities. The Working Group considers and responds to requests for comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

II. <u>COMMENTS OF THE WORKING GROUP</u>.

A. THE DEFINITION OF "FINANCIAL ENTITY" SHOULD NOT INCLUDE "CENTRAL DESKS" WITHIN COMMERCIAL ENTERPRISES.

- The definition of "financial entity" under the CEA refers to banking law which currently treats some trading of physical commodities and the trading of related derivatives as "financial activity."

- Many commercial firms have affiliates that face the market on behalf of the entire company. These market-facing affiliates allow a commercial firm to centralize its hedging, trading and marketing functions. Such companies may be improperly categorized as "financial entities" because of the cross-reference to the banking laws. As a result, certain commercial end-users will be treated like hedge funds and Congress's careful protections for end-users in the Dodd-Frank Act will be significantly diminished.

Recommendation: Amend the definition of "financial entity" to reflect original Congressional intent.

B. THE CFTC SHOULD NOT ALLOW THE *DE MINIMIS* LEVEL TO AUTOMATICALLY REDUCE.

- Under the CFTC's current rules, the *de minimis* level of swap dealing is set to automatically decrease by 60% within 5 years, and possibly sooner. This creates significant uncertainty for nonfinancial companies that engage in a small amount of swap dealing for the benefit of their customers.

- A change in the *de minimis* level would be a significant change in market structure. Congress should set the current $8 billion threshold as the statutory minimum. At the very least the CFTC should be required to undertake a formal rulemaking process in order to change the *de minimis* level. Currently, the prospect of a change in the *de minimis* level because of regulator inaction is very disruptive to market confidence.

- Finally, lowering the *de minimis* level below its current level will drive non-financial companies out of the business of offering their customers risk management products, limiting choices for end-users and further consolidating risk and swap activity in a small number of large Wall Street banks that may pose systemic risk.

Recommendation: Congress should legislatively establish the *de minimis* level at no less than $8 billion as contemplated under the current rule. At the very least Congress should require that any change to the level of the *de minimis* exception be undertaken through a formal rulemaking process and that the *de minimis* level not drop below its current level.

C. Forwards and Options that are Intended to be Physically Settled Should be Excluded from the Definition of "Swap."

- Under the CFTC's current guidance to the definition of "swap," routine commercial transactions that are completely unrelated to traditional financial contracts are considered swaps. These include options that result in the physical delivery of a commodity and forward contracts that contain some level of variability in how much of a physical product is ultimately delivered, but in all cases do involve the actual sale and delivery of a nonfinancial commodity.

- Regulating these transactions as swaps is inconsistent with the CEA's forward contract exclusion, which excludes from the definition of "swap" transactions that are "intended to be physically settled."

- These transactions ensure the efficient delivery of nonfinancial commodities to companies that require them to conduct their core physical businesses. They do not pose systemic risk and should not be treated like financial contracts and regulated as swaps.

- Even if physical commodity options are excluded from the definition of "swap," the CFTC will still have authority to regulate the transactions under Section 4c of the Commodity Exchange Act. The transactions just will not be regulated as financial products.

Recommendation: Amend the definition of "swap" to exclude physically settling commodity options.

D. The Use of the End-User Exception by an Affiliate Should be Workable.

- The CEA allows a financial entity to exercise the end-user exception on behalf of a non-financial affiliate if the financial entity is acting on behalf of and as an agent of the nonfinancial affiliate. The CFTC has interpreted this phrase to require an actual agency relationship to exist between the affiliates, which means that the nonfinancial entity must be a principal to the swap. This is contrary to common commercial practice.

- This narrow reading of the phrase vitiates Congress' intent. Requiring the nonfinancial end-user to enter into the swap as principal effectively eliminates the benefits realized by using central hedging affiliates.

Recommendation: Adopt H.R. 677.

E. Inter-affiliate Transactions Should not be Subject to CFTC Regulation.

- Currently, the CFTC's rules and proposed rules generally treat inter-affiliate swaps like any other swap. As such, among other things, companies must, under certain circumstances, report swaps between majority-owned affiliates and must submit such swaps to central clearing unless the end-user hedging exception applies or complex criteria for the inter-affiliate clearing exemption are met. The CFTC has provided relief in the form of no-action letters, but the no-action letters do not provide adequate relief in many circumstances.

- These regulations impose significant costs upon commercial firms, even though inter-affiliate swaps have little to no impact on the swap markets. For example, the CFTC estimates that compliance costs of its final rule setting forth an exemption from mandatory clearing for inter-affiliate swaps will be almost $700 million.

Recommendation: Adopt H.R. 677.

F. Position Limits Should only be Imposed by the CFTC After a Finding of Need and Effectiveness for a Specified Contract.

- Section 4a(a) of the CEA is clear that the CFTC may only implement federal speculative position limits as necessary to prevent excessive speculation. The CFTC has not defined "excessive speculation" and lacks any empirical, quantifiable evidence that large position concentrations harm the markets or the pricing of energy commodities.

- The CFTC should provide substantive cost-benefit analysis (i) establishing the need for the federal speculative position limits for the relevant energy contracts and (ii) discussing the effects that such limits may have on the markets for the relevant energy contracts.

Recommendation: Clarify that the CFTC must make an affirmative finding of need and effectiveness prior to enacting position limits.

G. The *Bona-Fide* Hedging Exemption from Position Limits Should be Amended to Reflect Current Market Practices.

- A properly functioning position limit regime is not only dependent on a clear understanding of deliverable supply for a particular commodity, but also on a workable hedge exemption process.

- In a change from prior practice, the CFTC's approach in the vacated position limits rule was to limit the availability of the *bona-fide* hedge exemption to a limited set of enumerated transaction forms.

- The *bona-fide hedge* exemption from position limits is necessary to allow end-users of physical commodities to properly hedge commercial risk. The CFTC's limitation of *bona-fide* hedges to enumerated transaction types is overly restrictive. A narrow or formula based definition of what constitutes *bona-fide* hedging will place significant limitations on many end-users' ability to hedge risk properly and efficiently.

Recommendation: Congress should require the CFTC to use general criteria that transactions must satisfy to be considered a *bona-fide* hedge, not just enumerated transaction forms.

H. THE CFTC SHOULD NOT FORCE THE AGGREGATION OF DERIVATIVES POSITIONS FOR POSITION LIMIT PURPOSES UNLESS CONTROL IS EXERCISED OR INFORMATION IS SHARED.

- The CFTC's approach under the vacated position limits rule treated majority ownership as irrebuttable proof that trading-level control existed, and required aggregation under such circumstances. As such, large commercial firms may be obligated to monitor the day-to-day trading activities of their affiliates regardless of whether they have control over or have direct knowledge about such affiliates' swaps trading.

- The rigid application of a majority ownership aggregation requirement does not further Congress' goal of preventing excessive speculation. The focus should be on aggregating positions where trading-level control or coordination exists.

Recommendation: The absence of trading-level control should obviate the need to aggregate for position limits purposes.

I. EXTRATERRITORIAL APPLICATION OF U.S. REGULATION SHOULD NOT HINDER U.S. INTERESTS ABROAD.

- Congress should direct the CFTC to ensure its rules and regulations (i) do not place U.S. companies at a disadvantage when transacting abroad and (ii) do not raise unnecessary barriers for non-U.S. companies seeking to trade in U.S. markets.

- Congress should direct the CFTC to allow U.S. persons and their affiliates to comply with regulations of the relevant nation when doing business abroad, as long as such regulations are consistent with the G-20's derivatives reform principles.

- Given the significance of this issue, Congress should require the CFTC to publish any cross-border guidance as an actual rule so a notice and comment period is required and a proper cost-benefit analysis is performed.

Recommendation: Adopt H.R. 1256.

J. COMMERCIAL FIRMS SHOULD NOT BE SUBJECT TO MARGIN REQUIREMENTS.

- Congress should make clear that it intended not only for margin requirements not to apply to nonfinancial end-users, but it also did not intend for the CFTC and Prudential Regulators to place limitations on the forms of collateral swap dealers and major swap participants can accept from nonfinancial end-users if they agree to collateralize a swap as a commercial matter.

Recommendation: Adopt H.R. 634.

K. THE CFTC'S COST BENEFIT ANALYSIS SHOULD BE IMPROVED.

- Throughout the Dodd-Frank implementation process, the CFTC's rulemakings have consistently not estimated or underestimated the potential costs of its rulemakings, many of which will have substantial impacts on derivatives markets. Similarly, the CFTC has consistently failed to provide meaningful evaluation of the expected benefits of its rules and to explain why one course of action is better than another.

- Congress should amend the CEA to ensure that the CFTC is required to provide thoroughly developed and reasonable estimates of the costs and benefits of its rulemakings.

Recommendation: Adopt H.R. 1003.

III. CONCLUSION.

The Working Group supports appropriate legislation and regulation that bring transparency and stability to the swap markets worldwide. The Working Group appreciates this opportunity to provide comments on the CFTC Reauthorization and respectfully requests that the Committee consider the comments set forth herein.

If you have any questions, please contact the undersigned.

Respectfully submitted,

/s/ David T. McIndoe
David T. McIndoe
Alexander S. Holtan

Counsel for The Commercial Energy Working Group

21653779.3

The Business Council for Sustainable Energy

July 23, 2013

The Honorable Debbie Stabenow, Chair
Senate Agriculture Committee
133 Hart Senate Office Building
Washington, DC 20510

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

Dear Chairwoman Stabenow and Ranking Member Cochran:

The Business Council for Sustainable Energy (BCSE) thanks the Committee for the opportunity to provide input as you prepare to review the Commodity Exchange Act (CEA) and reauthorize the Commodity Futures Trading Commission (CFTC) oversight of the futures and swaps markets.

The Business Council for Sustainable Energy is a coalition of companies and trade associations from the energy efficiency, natural gas and renewable energy sectors, and also includes independent electric power producers, investor-owned utilities, publicly-owned utilities, and commercial end-users. Founded in 1992, the Council advocates for policies that expand the use of commercially available clean energy technologies, products and services. The coalition's diverse business membership is united around the revitalization of the economy and the creation of a secure and reliable energy future for America. A document with information about BCSE is attached for your reference.

Earlier this year, BCSE and Bloomberg New Energy Finance (BNEF), a leading market research firm, released the *Sustainable Energy in America Factbook 2013.* The report is quantitative and objective and fills important gaps in existing data about clean energy in the United States, which is radically different from a generation ago. The *Factbook* provides up-to-date, accurate market intelligence about the broad range of industries — energy efficiency, renewable energy and natural gas — that are contributing to the country's shift towards cleaner energy production and more efficient energy usage. According to the *BCSE-BNEF Sustainable Energy in America Factbook 2013,* natural gas provided 31% of U.S. electricity in 2012, up from just 22% in 2007 and in April 2012 electricity generation from natural gas equaled that from coal for the first time in U.S. history. Moreover, natural gas and renewables combined now account for 57% of electric capacity in the United States. The *Factbook* notes the complimentary relationship between natural gas and renewables, as natural gas-fired electricity generation can quickly ramp up or down to meet changes in demand, and can complement the integrations of variable energy resources. This relationship is one way in which generators and grid operators are meeting the electricity needs of the country. Information about the *Factbook* is attached for your reference. For a complete copy of the *Factbook,* please visit our website at www.bcse.org/sustainableenergyfactbook.

These trends highlight the importance of ensuring that energy markets are able to function efficiently and that market rules recognize the interplay between a range of clean energy technologies and resources as we move to a more diverse energy system. Important to the interplay between clean energy technologies are forward contracts that include a degree of flexibility in the final delivery terms. These contracts allow market participants to adjust delivery volumes in response to changes in supply and demand requirements at the time of delivery. For example, on a day when weather conditions are not conducive to variable sources, a power generator may call on a greater volume of natural gas and can do so using the flexibility built into a forward contract. Importantly, the intent to physically deliver remains despite the flexibility in the final delivery terms.

1620 Eye Street NW • Suite 501 • Washington, DC 20006 • p: 202.785.0507 • f: 202.785.0514 • http://www.bcse.org

In its definition of the term "swap," the CFTC formulated rules that suggest that the Commission may regulate forward contracts with such flexibility as swaps. The CFTC's swap definition provides an interpretation that an agreement, contract or transaction with embedded optionality falls within the forward exclusion (and is not a swap) when seven criteria are met. The seven-criterion test is ambiguous in its application to forward contracts and creates uncertainty that may limit the willingness of market participants to use volumetric flexibility.

In light of the uncertainty created by the seven-criterion test, clarity regarding the applicability of the forward-contract exclusion to a physical contract with volumetric flexibility has become essential to energy producers and consumers. Given the importance of the definition of swap to implementation of so many other Dodd-Frank-Act-related CFTC regulations, clarity is crucial to the sound implementation of the Dodd-Frank Act. BCSE believes that Congress should amend the CEA to ensure that non-financial, physical energy contracts intended for physical delivery are not regulated as financial swaps. We look forward to working with the Committee to draft legislative language.

The swap definition is fundamental to implementation of the CFTC's new Dodd-Frank rules and the availability of cost-effective risk management tools is important to many in the energy markets. The BCSE is committed to working with you to achieve a positive outcome that both protects the integrity of commodity markets and ensures the continued availability of cost effective hedging tools.

Sincerely,

Lisa Jacobson, President
Attachments (3)

Cc: Members of the Senate Agriculture Committee

DTCC

55 WATER STREET
NEW YORK, NY 10041-0099

TEL: 212-855-3240
lthompson@dtcc.com

May 1, 2013

The Honorable Debbie Stabenow, Chairwoman
The Honorable Thad Cochran, Ranking Member
U.S. Senate Committee on Agriculture, Nutrition & Forestry
328A Russell Senate Office Building
Washington, D.C. 20510

Dear Chairwoman Stabenow and Ranking Member Cochran:

On behalf of The Depository Trust & Clearing Corporation ("DTCC"), thank you for the opportunity to provide input and recommendations with respect to the reauthorization of the Commodity Exchange Act ("CEA") and the Commodity Futures Trading Commission's ("CFTC's") oversight of the futures, swaps, and options markets.

DTCC serves as the primary financial market infrastructure serving the U.S. capital markets across multiple asset classes, including equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments, mutual funds, insurance, alternative investment products and over-the-counter derivatives. In 2012, thousands of companies issued securities through DTCC and its affiliated companies.

DTCC has operating facilities and data centers around the world and, through its subsidiaries, automates, centralizes, and standardizes the post-trade processing of financial transactions for thousands of institutions worldwide. In addition, DTCC has implemented the global legal entity identifier ("LEI") program through the assignment of CFTC Interim Compliant Identifiers ("CICI") since August 2012.

DTCC provides critical infrastructure to serve all participants in the financial industry, including investors, commercial end-users, broker-dealers, banks, insurance carriers, and approximately 500 mutual funds. DTCC operates as a cooperative that is owned collectively by its users and governed by a diverse Board of Directors. DTCC's governance structure includes 344 shareholders.

DTCC's subsidiary, the DTCC Data Repository (U.S.) LLC, is provisionally registered as a swap data repository ("SDR") with the CFTC for credit, equity, interest rate, foreign exchange and commodity derivatives in the U.S. In a joint venture with NYSE Euronext, DTCC launched New York Portfolio Clearing, LLC, a CFTC-registered derivatives clearing organization for U.S. dollar denominated U.S. Treasury and Eurodollar futures contracts.

As the Committee undertakes its comprehensive review of the CEA and the CFTC's role, including implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), DTCC recommends the consideration of the following important issues. These specific matters, if appropriately addressed, could aid in implementing Dodd-Frank and provide clarity and certainty to the CFTC and market participants.

Ensure Global Harmonization

Whether through international regulatory bodies such as the Committee on Payment and Settlement Systems ("CPSS")[1], the International Organization of Securities Commissions ("IOSCO")[2] or the OTC Derivatives Regulators' Forum[3] ("ODRF"), the Committee should encourage U.S. participation in global efforts to promote harmonized rules governing OTC swaps markets. As the Committee is aware, Asian and European regulators are hard at work at their own derivatives regulatory regimes, and the United States should promote international comity to ensure that regulatory arbitrage is not a driving force in market decisions.

We urge this Committee to continue its active oversight of Dodd-Frank implementation, including international coordination efforts, to ensure regulatory harmony among jurisdictions in a manner that promotes competition, transparency, and protects the safety and soundness of these global markets. At the same time, this Committee should remain vigilant that the international framework, including the implementation of a substituted compliance regime, is efficient and does not unfairly disadvantage or concentrate systemic risk in the United States.

[1] The CPSS is a standard setting body for payment, clearing and securities settlement systems. It also serves as a forum for central banks to monitor and analyse developments in domestic payment, clearing and settlement systems as well as in cross-border and multicurrency settlement schemes.

[2] The International Organization of Securities Commissions (IOSCO), established in 1983, is the acknowledged international body that brings together the world's securities regulators and is recognized as the global standard setter for the securities sector. IOSCO develops, implements, and promotes adherence to internationally recognized standards for securities regulation, and is working intensively with the G20 and the Financial Stability Board (FSB) on the global regulatory reform agenda. IOSCO's membership regulates more than 95% of the world's securities markets. Its members include over 120 securities regulators and 80 other securities markets participants (i.e. stock exchanges, financial regional and international organizations etc.). IOSCO is the only international financial regulatory organization which includes all the major emerging markets jurisdictions within its membership.

[3] The OTC Derivatives Regulators' Forum is comprised of international financial regulators including central banks, banking supervisors, and market regulators, and other governmental authorities that have direct authority over OTC derivatives market infrastructure providers or major OTC derivatives market participants, or consider OTC derivative market matters more broadly.

Reporting of All Swaps to Registered SDRs

During the CEA reauthorization, this Committee should ensure that the trade reporting requirement for all swaps remains the law of the land. CEA Section 2(a)(13)(G) requires that "[e]ach swap (whether cleared or uncleared) shall be reported to a registered swap data repository."[4] The CFTC described this new requirement as necessary "[t]o enhance transparency, promote standardization, and reduce systemic risk."[5]

We urge the Committee to maintain this important requirement that ensure regulators (and the public, through public dissemination by SDRs) have access to timely, accurate and consolidated information for all transactions within their jurisdiction. The bifurcation of trade reporting between cleared and uncleared swaps threatens only to fragment data between clearing houses and SDRs, making it more difficult for regulators to identify and mitigate systemic risk.

Indemnification

The Agriculture Committee should review Dodd-Frank's indemnification requirements and adopt a legislative remedy to remove the offensive provision that threatens global information sharing and systemic risk oversight.

Section 21(c) of the CEA requires, prior to sharing information with U.S. prudential regulators, the Financial Stability Oversight Council, the Department of Justice, foreign financial supervisors (including foreign futures authorities), foreign central banks, or foreign ministries, that (i) registered SDRs to receive a written agreement from each entity stating that the entity shall abide by certain confidentiality requirements relating to the information on swap transactions that is provided and (ii) each entity must agree to indemnify the SDR and the CFTC or the Securities and Exchange Commission (as applicable) for any expenses arising from litigation relating to the information provided.

In practice, this provision has proven to be unworkable. This Dodd-Frank requirement runs counter to ODRF policies and procedures to safeguard and share data and the IOSCO Multi-Lateral Memorandum of Understanding, poses a significant barrier to the ability of regulators globally to effectively utilize the transparency offered by trade repositories, and may have the effect of precluding US. regulators from data housed at non-U.S. repositories.

We urge you and your colleagues to consider and pass H.R. 742, the Swap Data Repository and Clearinghouse Indemnification Correction Act of 2013. This bill has been approved by the House Agriculture Committee with bipartisan support and

---

[4] CEA §2(a)(13)(G).

[5] Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2,136, 2,137 (Jan. 13, 2012).

has the support of the SEC and three CFTC Commissioners. H.R. 742 would conform U.S. law with existing international standards by removing the indemnification provisions from the CEA. Making this technical amendment would send a clear message to the international community that the United States is strongly committed to global data sharing and determined to avoid fragmenting the current global data set for over-the-counter derivatives.

Leverage Private Sector Data Analytics

During a recent Congressional hearing, Chairman Gensler revealed that the CFTC "won't have the resources for that technology, for analyzing the data, taking the data in and helping the public see the data in relevant aggregate forms."[6] During the CEA reauthorization process, the CFTC should be strongly encouraged to leverage existing private infrastructure to assist in its oversight of the futures and swaps markets.

DTCC, and other regulated entities (such as DCOs and SDRs), can provide unique analytics services if requested by the CFTC. The CFTC is receiving a tremendous amount of new information as a result of SDR reporting, but identifying abusive or manipulative trading or other signs of risk will be needles in the haystack unless the data can be converted into useful information. Providers of the data, including DCOs and SDRs, can provide analytic tools in their output to reduce the strain on the Commission and its limited resources.

We urge the Committee, in its oversight of the CFTC and Dodd-Frank implementation, to encourage the CFTC to seek input from private platforms and consider existing infrastructure that can be relied upon to provide the Commission with the technological capabilities to develop and implement systems and platforms for systemic risk oversight, particularly given the depth and breadth of data at the Commission's disposal under Dodd-Frank.

Thank you for your leadership on these very important issues. Should you wish to discuss these comments further, please contact me at 212-855-3240 or lthompson@dtcc.com.

Sincerely yours,

Larry E. Thompson

Larry E. Thompson
General Counsel

---

[6] Budget Hearing – Commodity Futures Trading Commission: Hearing before the Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies, 114th Cong. (2013).

Statement of

Larry Thompson
General Counsel

The Depository Trust & Clearing Corporation

Reauthorization of the Commodity Futures Trading Commission

Senate Committee on Agriculture, Nutrition & Forestry

July 17, 2013

Chairwoman Stabenow and Ranking Member Cochran:

On behalf of The Depository Trust & Clearing Corporation ("DTCC"), thank you for the opportunity to submit the following statement for the record in connection with your July 17, 2013 hearing, "Reauthorization of the Commodity Futures Trading Commission."

DTCC serves as the primary financial market infrastructure serving the U.S. capital markets across multiple asset classes, including equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments, mutual funds, insurance, alternative investment products and over-the-counter derivatives.

DTCC has operating facilities and data centers around the world and, through its subsidiaries, automates, centralizes, and standardizes the post-trade processing of financial transactions enabling thousands of institutions worldwide to issue securities and raise capital to build businesses.

DTCC provides critical infrastructure to serve all participants in the financial industry, including investors, commercial end-users, broker-dealers, banks, insurance carriers, and approximately 500 mutual funds. DTCC operates as a cooperative that is owned collectively by its users and governed by a diverse Board of Directors. DTCC's governance structure includes 344 shareholders.

DTCC's subsidiary, the DTCC Data Repository (U.S.) LLC ("DDR"), is provisionally registered as a swap data repository ("SDR") with the Commodity Futures Trading Commission ("CFTC") for credit, equity, interest rate, foreign exchange and commodity derivatives in the U.S. In addition, DTCC has implemented the global legal entity identifier program through the assignment of CFTC Interim Compliant Identifiers since August 2012.

DTCC has extensive experience operating as a trade repository and meeting transparency needs. We provide trade repository services in the U.S., the U.K., Japan, Singapore and the Netherlands and have established a global trio of fully replicated GTR data centers. DDR began accepting trade data from market participants on October 12, 2012 – the first day that financial institutions began trade reporting under the Dodd-Frank Wall Street Reform and Consumer Protection Act

("Dodd-Frank"). DTCC has been providing public aggregate information for the credit default swap market on a weekly basis, including both open positions and turnover data, since January 2009. This information is available, free of charge, on www.dtcc.com.

As the Committee considers reauthorization of the Commodity Exchange Act ("CEA") and the CFTC, DTCC suggests that the Committee review the following important issues. These specific matters, if appropriately addressed, could aid in implementing Dodd-Frank and provide clarity and certainty to the CFTC and market participants.

1. Protect Dodd-Frank Reporting of All Swaps to Registered SDRs

First, this Committee should ensure that the trade reporting requirement for all swaps remains the law of the land. CEA Section 2(a)(13)(G), added by Dodd-Frank, requires that "[e]ach swap (whether cleared or uncleared) shall be reported to a registered swap data repository."[1] The CFTC described this new requirement as necessary "[t]o enhance transparency, promote standardization, and reduce systemic risk."[2]

This provision was debated, analyzed, and considered throughout the Dodd-Frank legislative debate. Various iterations of draft statutory language were considered during this time, including numerous Congressional hearings and countless meetings. This decision to require the reporting of all swaps was a conscious decision by lawmakers to identify and mitigate systemic risk.

We urge the Committee to maintain this important requirement that ensure regulators (and the public, through public dissemination by SDRs) have access to timely, accurate and consolidated information for all transactions within their jurisdiction. The bifurcation of trade reporting between cleared and uncleared swaps threatens to fragment data between clearing houses and SDRs, making it more difficult for regulators to identify and mitigate systemic risk. Any changes made to this approach as a result of the CEA reauthorization process would reverse a thoughtful position arrived at after months of study and would hinder regulatory oversight of over-the-counter ("OTC") swaps markets.

2. Approve Technical Corrections to Dodd-Frank Indemnification Provisions

This Committee should review Dodd-Frank's indemnification requirements and pass a legislative remedy to remove the offensive provision that threatens global information sharing and systemic risk oversight.

DTCC strongly encourages the Committee to consider this critical technical correction as it undertakes its comprehensive review of CFTC reauthorization. Making this technical amendment would send a clear message to the international community that the United States is strongly committed to global data sharing and determined to avoid fragmenting the current global data set for OTC derivatives.

---

[1] CEA §2(a)(13)(G).

[2] Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2,136, 2,137 (Jan. 13, 2012).

The indemnification requirement in Section 21(c) of the CEA requires, prior to sharing information with U.S. prudential regulators, the Financial Stability Oversight Council, the Department of Justice, foreign financial supervisors (including foreign futures authorities), foreign central banks, or foreign ministries, that (i) registered SDRs to receive a written agreement from each entity stating that the entity shall abide by certain confidentiality requirements relating to the information on swap transactions that is provided and (ii) each entity must agree to indemnify the SDR and the CFTC or the Securities and Exchange Commission (as applicable) for any expenses arising from litigation relating to the information provided.

In practice, this provision has proven to be unworkable. This Dodd-Frank requirement runs counter to policies and procedures adopted by global regulatory bodies to safeguard and share data, poses a significant barrier to the ability of regulators globally to effectively utilize the transparency offered by trade repositories, and may have the effect of precluding U.S. regulators from seeing data housed at non-U.S. repositories.

The Swap Data Repository and Clearinghouse Indemnification Correction Act of 2013 (H.R. 742), would conform U.S. law with existing international standards by removing the indemnification provisions from the CEA. H.R. 742 was approved by the House in a 420-2 recorded vote on June 12 and has the support of the SEC[3] and three CFTC Commissioners.[4]

Additionally, in a May 3 letter[5] to this Committee, the Americans for Financial Reform (AFR) noted that H.R. 742 is a non-controversial technical correction that could improve regulatory effectiveness and stated that they did not oppose the legislation.

DTCC strongly encourages the Committee to consider this critical technical correction as it undertakes its comprehensive review of CFTC reauthorization. Making this technical amendment would send a clear message to the international community that the United States is strongly committed to global data sharing and determined to avoid fragmenting the current global data set for OTC derivatives.

3. **Regulators Should Leverage Private Sector Data Analytics**

During an April 2013 Congressional hearing, Chairman Gensler revealed that the CFTC "won't have the resources for that technology, for analyzing the data, taking the data in and helping the

[3] Chairman Elisse Walter, Secs. and Exch. Comm'n, Remarks at the American Bar Association Spring Meeting, Regulation of Cross-Border OTC Derivatives Activities: Finding the Middle Ground (Apr. 6, 2013).

[4] *See* Commissioner Jill Sommers and Commissioner Scott O'Malia, Dissenting Statement, Interpretative Statement Regarding the Confidentiality and Indemnification Provisions of Section 21(d) of the Commodity Exchange Act, *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/sommers_omailadissentstatement; *see also* Dodd-Frank Derivatives Reform: Challenges Facing U.S. and International Markets: Hearing Before the H. Comm. on Agric., 112th Cong. (2012) (Commissioner Bart Chilton expressing support for a legislative solution), transcript *available at* http://agriculture.house.gov/sites/republicans.agriculture.house.gov/files/transcripts/112/112-35New.pdf.

[5] *Available at* http://www.ag.senate.gov/download/?id=90d5a93c-5a4e-458c-9a67-e2135b17aff8

public see the data in relevant aggregate forms."[6] During the CEA reauthorization process, the CFTC should be strongly encouraged to leverage existing private infrastructure to assist in its oversight of the futures and swaps markets.

DTCC, and other regulated entities (such as derivatives clearing organizations ("DCOs") and SDRs), can provide unique analytics services if requested by the CFTC. The CFTC is receiving a tremendous amount of new information as a result of SDR reporting, but identifying abusive or manipulative trading or other signs of risk will be needles in the haystack unless the data can be converted into useful information. Providers of the data, including DCOs and SDRs, can provide analytic tools in their output to reduce the strain on the Commission and its limited resources.

We urge the Committee, in its oversight of the CFTC and Dodd-Frank implementation, to encourage the CFTC to seek input from private platforms and consider existing infrastructure that can be relied upon to provide the Commission with the technological capabilities to develop and implement systems and platforms for systemic risk oversight, particularly given the depth and breadth of data at the Commission's disposal under Dodd-Frank.

4. Ensure Global Harmonization

Whether through international regulatory bodies such as the Committee on Payment and Settlement Systems ("CPSS")[7], the International Organization of Securities Commissions ("IOSCO")[8] or the OTC Derivatives Regulators' Forum ("ODRF")[9], the Committee should encourage U.S. participation in global efforts to promote harmonized rules governing OTC swaps markets. As the Committee is aware, while the CFTC recently completed its cross-border interpretive guidance, Asian and European regulators are hard at work at their own derivatives regulatory regimes, and the United States should promote international comity to ensure that regulatory arbitrage is not a driving force in market decisions.

We urge this Committee to continue its active oversight of Dodd-Frank implementation, including international coordination efforts, to ensure regulatory harmony among jurisdictions in

[6] Budget Hearing – Commodity Futures Trading Commission: Hearing before the Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies, 114th Cong. (2013).

[7] The CPSS is a standard setting body for payment, clearing and securities settlement systems. It also serves as a forum for central banks to monitor and analyse developments in domestic payment, clearing and settlement systems as well as in cross-border and multicurrency settlement schemes.

[8] The International Organization of Securities Commissions (IOSCO), established in 1983, is the acknowledged international body that brings together the world's securities regulators and is recognized as the global standard setter for the securities sector. IOSCO develops, implements, and promotes adherence to internationally recognized standards for securities regulation, and is working intensively with the G20 and the Financial Stability Board (FSB) on the global regulatory reform agenda. IOSCO's membership regulates more than 95% of the world's securities markets. Its members include over 120 securities regulators and 80 other securities markets participants (i.e. stock exchanges, financial regional and international organizations etc.). IOSCO is the only international financial regulatory organization which includes all the major emerging markets jurisdictions within its membership.

[9] The OTC Derivatives Regulators' Forum is comprised of international financial regulators including central banks, banking supervisors, and market regulators, and other governmental authorities that have direct authority over OTC derivatives market infrastructure providers or major OTC derivatives market participants, or consider OTC derivative market matters more broadly.

a manner that promotes competition, transparency, and protects the safety and soundness of these global markets. At the same time, this Committee should remain vigilant that the international framework, including the implementation of a substituted compliance regime, is efficient and does not unfairly disadvantage or concentrate systemic risk in the United States.

Thank you for the opportunity to provide this statement. DTCC looks forward to working with the Committee on reauthorization of the CEA and the future of the CFTC.

THE FARM CREDIT COUNCIL

May 1, 2013

By email to:
cftcreauthorization@ag.senate.gov

The Honorable Debbie Stabenow
Chairwoman
U.S. Senate Committee on
Agriculture, Nutrition & Forestry
328A Russell Senate Office Building
Washington, D.C. 20510

The Honorable Thad Cochran
Ranking Member
U.S. Senate Committee on
Agriculture, Nutrition & Forestry
328A Russell Senate Office Building
Washington, D.C. 20510

Re: CFTC Reauthorization

Dear Chairwoman Stabenow and Ranking Member Cochran:

On behalf of its members, the Farm Credit Council appreciates the opportunity to provide its input regarding this year's reauthorization of the Commodity Futures Trading Commission ("CFTC") and the ongoing implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1]

The Farm Credit Council is the national trade association for the Farm Credit System, a government instrumentality created "to accomplish the objective of improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related businesses necessary for efficient farm operations."[2] Today, the Farm Credit System comprises four banks and 82 associations, which are cooperatively owned by their member-borrowers.

As you recognized in soliciting comments from members of the public, this year's reauthorization of the CFTC comes at an important time, as that agency continues to implement

---

1 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2 12 U.S.C. § 2001(a).

Dodd-Frank and address rapidly evolving market conditions. The Farm Credit Council is interested in these developments because Farm Credit System institutions rely on the safe use of derivatives to manage interest rate, liquidity, and balance sheet risk. The safe use of derivatives allows the Farm Credit System to offer reliable, low-cost, and flexible funding to the farmers, ranchers, and rural cooperatives that borrow from, and cooperatively own, Farm Credit System institutions.

CFTC Implementation of Dodd-Frank to Date

The Farm Credit Council commends the CFTC for a number of measures that the agency has taken to implement Dodd-Frank in a manner that mitigates systemic risk and increases transparency, without imposing burdensome new costs on cooperative financial institutions like the Farm Credit System. As described further below, in several contexts, the CFTC has appropriately recognized that cooperative entities, like Farm Credit System institutions, should be exempt from certain new regulatory requirements. In addition, the Farm Credit Council strongly supports the CFTC's proposal, which has not yet been finalized, to provide an exemption from the clearing requirement that would cover Farm Credit System institutions.

Entity Definitions. In May 2012, the CFTC, jointly with the Securities and Exchange Commission, issued final rules further defining certain entities subject to regulation under Dodd-Frank.[3] The joint final rules further defining "swap dealer" recognize that a cooperative financial institution, such as a Farm Credit System institution, will not be required to register as a swap dealer based on the notional amount of swaps entered into with its members.[4] In adopting an exception for cooperatives, the CFTC recognized that a swap between a Farm Credit System institution and one of its members does not warrant the same entity-level, swap dealer regulation as a swap between a Wall Street swap dealer and its unrelated customer. This is because the former swap "serves to allocate or transfer risks within an affiliated group, rather than to move those risks from the group to an unaffiliated third party, so long as the cooperative adheres to certain risk management practices."[5]

---

3 *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30,596 (May 23, 2012).

4 *See id.* at 30,625, 30,746 (17 C.F.R. § 1.3(ggg)(6)(ii)).

5 *Id.* at 30,625.

End-User Clearing Exception. In July 2012, the CFTC issued a final rule implementing the end-user exception to the clearing requirement for swaps.[6] Under that rule, the end-user clearing exception will be available to a small financial entity only if its total assets are $10 billion or less.[7] Because of the $10 billion asset threshold, certain Farm Credit Banks will be unable to qualify for the end-user clearing exception. The CFTC recognized, however, that "cooperatives exist to serve their member owners"; "some cooperatives represent their members in the financial markets, and the members of some of these cooperatives are entities that could elect the end-user exception if acting alone"; and for these reasons, exemptive relief for cooperatives would be appropriate.[8]

Proposed Cooperative Exemption. Separately in July 2012, the CFTC unanimously issued a proposed rule providing that an "exempt cooperative," such as a Farm Credit System institution, may elect not to clear swaps used to hedge or mitigate commercial risk related to loans to its members.[9] In support of its proposal, the CFTC explained that cooperatives exist for the benefit of, and cannot be separated from, their member owners.[10] The CFTC recognized that member owners of a financial entity could elect the end-user exception if acting alone, but could not do so collectively with other member owners at the level of a cooperative financial entity with total assets exceeding $10 billion.[11] To address this issue, the CFTC proposed exemptive relief for cooperative financial institutions, such as a Farm Credit Bank. In doing so, the CFTC concluded, among other things, that "[u]sing the substantial, finance-focused resources of the cooperative to undertake hedging activities for the numerous members of the cooperative promotes greater economic efficiency and lower costs for the members," and the proposed cooperative exemption therefore "would promote responsible

---

6 *See* End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42,560 (July 19, 2012) (17 C.F.R. § 50.50).

7 *See id.* at 42,591 (17 C.F.R. § 50.50(d)).

8 *Id.* at 42,580.

9 *See* Clearing Exemption for Certain Swaps Entered Into by Cooperatives, 77 Fed. Reg. 41,940 (proposed July 17, 2012).

10 *See id.* at 41,943 ("Cooperatives have a member ownership structure in which the cooperatives exist to serve their member owners and do not act for their own profit. Furthermore, the member owners of the cooperative collectively have full control and governance of the cooperative. In a real sense, the cooperative is not separable from its member owners." (footnote omitted)).

11 *See id.* ("[T]he cooperative members would not benefit from the end-user exception if they use their cooperative as the preferred vehicle for hedging commercial risks in the greater financial marketplace. In light of this, the Commission is exercising its authority under Section 4(c) of the CEA to propose § 39.6(f) and establish the cooperative exemption.").

economic and financial innovation and fair competition."[12] The Farm Credit Council strongly supports the proposed cooperative exemption, which has not yet been finalized.

No-Action Relief for Cooperatives. On November 28, 2012, the same day the CFTC determined that credit default swaps and interest rate swaps would be required to be cleared, the CFTC's Division of Clearing and Risk issued a no-action letter stating that it will not recommend that the CFTC commence an enforcement action for failure to clear a credit default swap or an interest rate swap, provided that certain requirements, which essentially follow the provisions of the proposed cooperative exemption, are satisfied.[13] This no-action relief expired on April 1, 2013.[14]

Ongoing CFTC Implementation of Dodd-Frank

The Farm Credit Council commends the CFTC for proposing to exempt cooperative financial entities, such as Farm Credit System institutions, from the clearing requirement. The Farm Credit Council is hopeful that the CFTC will take action to finalize the proposed cooperative exemption soon. Such action is important because, under the CFTC's phased implementation schedule for compliance with the clearing requirement, absent exemptive relief, Farm Credit System institutions will be required to start clearing interest rate swaps on June 10, 2013.[15] As the CFTC recognized in proposing the cooperative exemption, mandatory clearing will operate to raise the cost of credit for the cooperative members of the Farm Credit System — America's farmers, ranchers, and farm-related businesses — without reducing systemic risk.

* * * * *

We appreciate your invitation to submit these comments concerning the CFTC's ongoing implementation of Dodd-Frank, and we thank you for your leadership on these important matters.

---

12 *Id.* at 41,943-44.

13 CFTC Letter No. 12-36, Re: Time-Limited No-Action Relief from the Clearing Requirement for Swaps Entered Into By Cooperatives (Nov. 28, 2012), *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-36.pdf.

14 *See id.* at 3.

15 *See* Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74,284, 74,289 n.52, 74,320 (Dec. 13, 2012) (to be codified at 17 C.F.R. pts. 39 & 50).

Sincerely,

Kenneth E. Auer
President and CEO
Farm Credit Council

cc: Honorable Gary Gensler, Chairman
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott D. O'Malia, Commissioner
Honorable Mark P. Wetjen, Commissioner
Commodity Futures Trading Commission

THE FARM CREDIT COUNCIL

July 18, 2013

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

Honorable Thad Cochran
Ranking Member
U.S. Senate Committee on Agriculture,
Nutrition & Forestry
328A Russell Senate Office Building
Washington, DC 20510

Re: CFTC Reauthorization

Dear Chairwoman Stabenow and Ranking Member Cochran:

On behalf of its members, the Farm Credit Council appreciates the opportunity to submit this letter concerning the reauthorization of the Commodity Futures Trading Commission ("CFTC").

The Farm Credit Council is the national trade association for the Farm Credit System. The System was created "to accomplish the objective of improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related businesses necessary for efficient farm operations."[1] Today, the Farm Credit System comprises four banks and 82 associations, all of which are cooperatively owned by their member-borrowers.

This year's reauthorization of the CFTC comes at an important time, as that agency continues to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and to address rapidly evolving market conditions. The Farm Credit Council is interested in these developments because Farm Credit System institutions rely on the safe use of derivatives to manage interest rate, liquidity, and balance sheet risk. The safe use of derivatives allows the Farm Credit System to offer reliable, competitive, and flexible financing to the farmers, ranchers, and rural cooperatives that borrow from, and cooperatively own, Farm Credit System institutions.

---

1 12 U.S.C. § 2001(a).

CFTC Cooperative Clearing Exemption

The Farm Credit Council commends the CFTC for a number of measures that the agency has taken to implement Dodd-Frank in a manner that mitigates systemic risk and increases transparency, without imposing burdensome new costs on cooperative financial institutions like the Farm Credit System.

For example, as we explained in our May 1, 2013 letter to the Committee, by a unanimous vote of its Commissioners in July 2012, the CFTC proposed a rule providing that an "exempt cooperative," such as a Farm Credit System institution, may elect not to clear swaps used to hedge or mitigate commercial risk related to loans to its members.[2] In support of its proposal, the CFTC explained that cooperatives exist for the benefit of, and cannot be separated from, their member owners.[3] The CFTC recognized that member owners of a financial entity could elect the end-user exception if acting alone, but could not do so collectively with other member owners at the level of a cooperative financial entity with total assets exceeding $10 billion.[4] To address this issue, the CFTC proposed exemptive relief for cooperative financial institutions, such as a Farm Credit Bank. In doing so, the CFTC concluded, among other things, that "[u]sing the substantial, finance-focused resources of the cooperative to undertake hedging activities for the numerous members of the cooperative promotes greater economic efficiency and lower costs for the members," and the proposed cooperative exemption therefore "would promote responsible economic and financial innovation and fair competition."[5]

The Farm Credit Council strongly supports the proposed cooperative exemption, which has not yet been finalized. Pending the issuance of a final rule implementing the cooperative exemption, the CFTC's Division of Clearing and Risk has issued several no-action letters stating that it will not recommend that the CFTC commence an enforcement action for failure to clear a credit default swap or an interest rate swap, provided that certain requirements,

---

2 *See* Clearing Exemption for Certain Swaps Entered Into by Cooperatives, 77 Fed. Reg. 41,940 (proposed July 17, 2012).

3 *See id.* at 41,943 ("Cooperatives have a member ownership structure in which the cooperatives exist to serve their member owners and do not act for their own profit. Furthermore, the member owners of the cooperative collectively have full control and governance of the cooperative. In a real sense, the cooperative is not separable from its member owners." (footnote omitted)).

4 *See id.* ("[T]he cooperative members would not benefit from the end-user exception if they use their cooperative as the preferred vehicle for hedging commercial risks in the greater financial marketplace. In light of this, the Commission is exercising its authority under Section 4(c) of the CEA to propose § 39.6(f) and establish the cooperative exemption.").

5 *Id.* at 41,943-44.

which are "essentially the same" as the requirements of the proposed cooperative exemption, are satisfied.[6] The last-issued no-action relief will expire on July 19, 2013.

It is important for the CFTC to take action to finalize the proposed cooperative exemption soon because, under the CFTC's phased implementation schedule for compliance with the clearing requirement, Farm Credit System institutions will be required to clear interest rate swaps when the no-action relief discussed above expires.[7] As the CFTC recognized in proposing the cooperative exemption, mandatory clearing will operate to raise the cost of credit for the cooperative members of the Farm Credit System — America's farmers, ranchers, and farm-related businesses — without reducing systemic risk.

Application of Margin Requirements to Exempt Cooperatives

The Farm Credit Council also wants to commend the Committee for its continued leadership in addressing the CFTC's implementation of Dodd-Frank. In that regard, the Farm Credit Council urges the Committee to take up consideration of H.R. 634, the Business Risk Mitigation and Price Stabilization Act of 2013. H.R. 634 recently passed the House of Representatives by a vote of 411-12, reflecting a strong bipartisan consensus. H.R. 634 provides, among other things, that initial and variation margin requirements "shall not apply to a swap in which a counterparty qualifies for ... an exemption issued under section 4(c)(1) from the requirements of section 2(h)(1)(A) [the "clearing requirement"] for cooperative entities as defined in such exemption."[8] This provision would make clear that margin requirements should not be imposed on Farm Credit System institutions, or other qualifying cooperative entities, with respect to their uncleared swaps.

The Farm Credit Council strongly supports H.R. 634 and recommends that the Committee favorably report the legislation to the full Senate for its consideration. The CFTC's

---

6 CFTC Letter No. 12-36, Re: Time-Limited No-Action Relief from the Clearing Requirement for Swaps Entered Into By Cooperatives (Nov. 28, 2012), *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-36.pdf; CFTC Letter No. 13-24, Re: Time-Limited No-Action Relief from the Clearing Requirement for Swaps Entered into by Cooperatives (Jun. 7, 2013), *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-24.pdf; CFTC Letter No. 13-30, Re: Extension of Time-Limited No-Action Relief from the Clearing Requirement for Swaps Entered into by Cooperatives (Jun. 21, 2013), *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-30.pdf.

7 *See* Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74,284, 74,289 n.52, 74,320 (Dec. 13, 2012) (to be codified at 17 C.F.R. pts. 39 & 50).

8 H.R. 634, 113th Cong. § 2 (passed the House of Representatives June 12, 2013).

proposed cooperative clearing exemption would spare cooperative entities, like Farm Credit System institutions, the costs of margin associated with mandatory clearing. H.R. 634 would similarly spare the same entities the costs of margin associated with uncleared swaps. Both proposals reflect the sound policy determination that swaps entered into by cooperative entities, such as Farm Credit System institutions, serve important purposes for members of cooperatives and the larger economy, while presenting minimal risk to the U.S. financial system. If implemented, both proposals should allow Farm Credit System institutions to manage risk by negotiating responsible collateral arrangements directly with their swap counterparties.

Achieving this result depends, however, on the CFTC's final implementation of its proposed clearing exemption for cooperatives and on the recognition by regulators that Congress intends that margin requirements will not be imposed on Farm Credit System institutions. If implemented, the CFTC's proposed cooperative exemption would be "an exemption issued under section 4(c)(1) from the requirements of section 2(h)(1)(A) for cooperative entities" under H.R. 634. Until the CFTC finalizes the exemption, however, the Farm Credit System will not secure the relief that H.R. 634 was intended to provide.[9]

If the CFTC finalizes its proposed cooperative exemption and H.R. 634 is enacted, H.R. 634 will prohibit the CFTC and the prudential regulators, including the Farm Credit Administration, from imposing margin requirements on cooperative entities under Section 4s(e) of the Commodity Exchange Act. This makes sense. Such requirements would divert capital otherwise used for loans to farmers, ranchers, and farm-related businesses into margin payments, diminish the Farm Credit System's members' access to credit, and adversely affect the American economy, especially in rural and agricultural communities. The Farm Credit Council urges this Committee to address this important issue.

Notwithstanding that the House of Representatives and the CFTC have expressed their intent that margin requirements (either associated with clearing or with respect to uncleared swaps) should not apply to Farm Credit System institutions, the Farm Credit Administration has

---

[9] The Farm Credit Council also supports H.R. 2136, the Small Business Credit Availability Act, pending before the House Committee on Agriculture. By excluding a Farm Credit System institution whose aggregate uncollateralized outward exposure plus aggregate potential outward exposure does not exceed $1 billion from the definition of "financial entity" in Section 2(h)(7)(C)(ii) of the Commodity Exchange Act, H.R. 2136 would effectively allow Farm Credit System institutions to qualify for the end-user exception to the clearing requirement under Section 2(h)(7)(A) of the Commodity Exchange Act, subject to the swap exposure threshold. If the Farm Credit System institution qualified for the end-user exception, H.R. 634 would then operate to prohibit margin requirements from being imposed on uncleared swaps entered into by the same institution. In conjunction with H.R. 634, H.R. 2136 would make clear that margin requirements (imposed either by clearinghouses or by regulators on uncleared swaps) should not apply to Farm Credit System institutions.

suggested that it has authority — separate from the provisions of the Commodity Exchange Act added by Dodd-Frank — to impose "special" margin requirements on swaps to which a Farm Credit System institution is a counterparty.[10] Pursuant to this authority, the Farm Credit Administration has proposed to require Farm Credit System institutions to collect initial and variation margin from swap dealer or major swap participant ("swap entity") counterparties.[11]

The Farm Credit Administration's proposal would frustrate the clear intent of H.R. 634 and the CFTC's proposed cooperative exemption. The requirement to collect margin from swap entity counterparties will, no doubt, increase the costs of uncleared swaps. It will likely further result in swap entities requiring reciprocal margin obligations from Farm Credit System institutions. This result would undo the very relief that would be provided by the CFTC's proposed cooperative exemption and H.R. 634. The Farm Credit Council believes that this would be contrary to the intent of this legislation and the principal regulator charged with implementing new derivatives regulation.

* * * * *

The Farm Credit Council appreciates the opportunity to submit this letter concerning the reauthorization of the CFTC, and thanks the Committee for its continued leadership on these important matters.

Sincerely,

Kenneth E. Auer

Kenneth E. Auer
President and CEO
Farm Credit Council

cc: Honorable Gary Gensler, Chairman
Honorable Bart Chilton, Commissioner
Honorable Scott D. O'Malia, Commissioner

---

10 *See* Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564, 27,583 (proposed May 11, 2011) (to be codified at 12 C.F.R. pt. 624).

11 *Id.* at 27,595 (proposed 12 C.F.R. § 624.11).

Honorable Mark P. Wetjen, Commissioner
Commodity Futures Trading Commission

Gary K. Van Meter, Director, Office of Regulatory Policy,
Farm Credit Administration

UNITED STATES CATTLEMEN'S association

web: www.uscattlemen.org ~ email: usca@uscattlemen.org
2414 I St. NW Washington, D.C. 20037 – (202)870-3867

April 30, 2013

The Honorable Debbie Stabenow
Chairwoman
Committee on Agriculture, Nutrition & Forestry
U.S. Senate
Washington, DC 20510

The Honorable Thad Cochran
Ranking Member
Committee on Agriculture, Nutrition & Forestry
U.S. Senate
Washington, DC 20510

<u>Re:</u> Comments Submitted to the United States Senate Committee on Agriculture, Nutrition and Forestry regarding public input for CFTC Reauthorization

The United State Cattlemen's Association (USCA) would like to thank you for the opportunity to comment on the matter of reauthorization of the Commodity Futures Trading Commission (CFTC). Our membership represents agricultural producers involved in the production of crops and livestock. Managing risk has become a key part of determining the financial success of our operations and we have a great interest and personal investment in improving the integrity of the futures markets. Recent failures of MF Global and Peregrine Financial have caused great hardship to market participants in ways that should not even be possible. We hope you are able to convey to the CFTC the need to "get their house in order."

Specifically, we suggest discussion be focused on the causes of the oversight failures involved in the recent collapse of the above mentioned commodity firms and what is being done to ensure such lapses in oversight are not repeated. Secondly, it is vital that the solutions to the oversight failures not place any undue hardship onto the market participants. The remedies to ensure such collapses within the commodity market do not occur in the future should not increase costs of operation to market participants. Lastly, consideration must be given to increasing the authority of the CFTC in ways similar to the Securities Exchange Commission (SEC).

The U.S. Cattlemen's Association believes the CFTC owes the Committee, and those that have been affected by these events, a candid explanation about the causes of oversight failure and means by which the commission is working to ensure such lapses are not repeated.

The fraud surrounding the Peregrine collapse is reported to have begun in the mid 1990's; for this to have occurred undetected over a period of multiple decades, points to procedural incompetency that no amount of additional money can fix. USCA has received multiple inquiries from our membership asking the question: Who is being held accountable at the CFTC for the Peregrine failure? In terms of both cases, no one has yet been held accountable from MF Global and only one person in association with Peregrine has been indicated.
The scale at which these events have occurred suggests that multiple individuals in both organizations had to be aware of and therefore negligent in their duties for such vast sums of

funds to simply disappear. It must be asked that if no one is held accountable, if not for fraud then at the very least for a breach of responsibility, where is the deterrent for the rest of the industry? If integrity in the markets is to be restored we must have individuals within this sector aware that there will be personal consequences when anyone from the CEO to the finance department allows events such as these that are outside the legal realm of procedure to occur.

The root of these corporations' failures must first be understood when examining this issue. Participant margin defaults are not the cause and as such any solutions reached on this issue should not involve increased cost, especially related to margin requirements, for the market participants who were not at fault. In addition to potential increased operating costs, proposed margin increases or shorter time frames in which one must meet such stated requirements will also cause an increase to the funds at risk for the market participants.

The producers represented by USCA differ from speculators in that margin funds represent operating capital, often borrowed, instead of funds invested for known risk of loss. Why is there not total segregation of those funds from the commodity firm's? Some have suggested insurance as a remedy. Again, we are hesitant to add cost to the industry. These accounts differ from bank accounts which are known to be used by the bank to lend, and therefore at risk of default, thus potentially taking down the bank if not managed right. If margin accounts are completely segregated and effective oversight is taking place, there should be no risk of loss to those accounts held by our producers.

Finally, we encourage the Committee to facilitate a discussion focused on the potential merits of increasing the authority of the CFTC to be similar in its ability to provide oversight as the SEC is in the equity markets. Consideration must also be given to the adequacy of the CFTC to levy fines; the deterrent force in these markets must be strong.

We ask that the Committee allocates the time necessary to ensure a robust discussion with the CFTC takes place and is one that addresses the issues outlined above. Commodity markets are crucial to the efficient operation of our entire food production system. The industry must have confidence restored in the oversight and control of this marketplace. Thank you for your consideration; please do not hesitate to contact Allan Sents, USCA Committee Chair on Marketing and Competition at (785) 546-2216, if you are in need of additional information or clarification on this issue.

Sincerely,

Allan Sents
USCA Board of Director, Committee Chair on Marketing and Competition

U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5000
Facsimile: (202) 418-5521
www.cftc.gov

Office of the Commissioner

Bart Chilton

202.418.5060
bchilton@cftc.gov

July 19, 2013

The Honorable Debbie Stabenow
Chairwoman
U.S. Senate Committee on Agriculture Nutrition & Forestry
133 Hart Senate Office Building
Washington, DC 20510

Dear Chairwoman Stabenow:

I am writing to you regarding the upcoming reauthorization of the CFTC. Thank you for your leadership during this time period. Please find attached four proposals that I regard as most pertinent to the mission of the Commodity Futures Trading Commission:

1.) Derivatives Markets Insurance Fund ("DMIF")
2.) Assessment of Penalties—Need for Enhanced Enforcement Authority
3.) High Frequency Traders ("HFTs") Need for Federal Oversight
4.) Targeted Transaction Fee (TTF) Proposal

I look forward to working with you regarding the reauthorization of the CFTC.

Sincerely,

Bart Chilton

Derivatives Markets Insurance Fund ("DMIF")

Congressional establishment of a DMIF, based on the insurance protections currently in place in the securities world (SIPC), would provide needed safeguards for investors in U.S. derivatives markets.

Why Is This Type of Fund Necessary?

- Because over $35 billion in derivatives customer property has been exposed to insolvency since the onset of the 2008 financial crisis. As we saw in the MFGlobal debacle, something more than segregation of funds needs to be done to protect consumers.

How Would Such a Fund be Implemented?

- By drawing on existing legislative blueprints, creation of a DMIF would be relatively simple for legislators and for DMIF administrators.
- The costs to fund and administer a DMIF would be minimal compared to the benefits of enhanced market confidence and consumer protection.

What would DMIF do?

- It would provide U.S. derivatives markets customers with a more efficient and effective method to reimburse funds put at risk in cases of insolvency, and equalize the bankruptcy treatment for derivatives and securities investors. It would provide U.S. derivatives markets customers the right to file claims with a bankruptcy trustee for priority treatment.
- The DMIF would be overseen by legislatively-created Derivatives Market Insurance Fund Corporation, or "DMIFC." DMIFC would be controlled by a three-member board of directors, confirmed by a Senate majority vote. Operational expenses would be minimal. The CFTC and DMIFC would coordinate oversight, just as the SEC and SIPC do.
- The initial collection for the fund could be based on fees assessed on all derivatives market intermediary brokers (futures commission merchants, or "FCMs"). After reaching an initial target level (never to exceed a specified level, for example, $2.5 billion), the DMIFC and the Board of could lower or suspend assessments.

<u>Assessment of Penalties—Need for Enhanced Enforcement Authority</u>

The CFTC needs enhanced authority to assess meaningful penalties against wrongdoers.

Why Is Enhanced Penalty Authority Necessary?

- The CFTC is authorized to assess fines on a "per violation" basis. The amount of fines varies statutorily from $140,000 "per violation" in some cases to $1 million per violation in the case of market manipulation.
- Currently, the definition of "per violation" is open to interpretation. This could mean that "per violation" in a market manipulation case could be based on one day, therefore garnering only a $1million fine. When market participants benefit from illegal schemes sometimes in the billions of dollars, such small fines can come to be viewed as just a "cost of doing business" for malfeasors.
- With new types of trading—particularly high frequency trading—that can move markets in milliseconds, "per violation" needs to be interpreted appropriately, for example, on a "per second" basis.

How Should Penalties Be Assessed?

- At a minimum, the CFTC needs to ability to ensure that "the punishment fits the crime."
- Statutory flexibility in determining "per violation" would allow the agency to adjust requested fines (and to negotiate appropriate settlements) to be meaningful deterrents to violative conduct.

What Should Be Included In CFTC's Statutory Penalty Authority?

- Unambiguous statutory flexibility in determining what "per violation" means.
- Increased penalty minimums assessed on individual and entity bases. Currently, we can assess $140,000 per violation of the CEA, and $1,000,000 per violation for manipulation. These levels should be increased to $1,000,000 per individual for every violation of the CEA; and $10,000,000 per entity for each violation.

High Frequency Traders ("HFTs") Need for Federal Oversight

Increased HFT oversight should be mandated to increase the regulatory responsibility of the CFTC. This enhanced authority to oversee HFTs is necessary to protect U.S. markets and consumers. (I've referred to HFTs as "cheetah traders," because in our fast-paced financial markets, they are the fastest of the fast.) Congressional direction to the agency is needed, inasmuch as the agency has been reluctant to impose increased HFT regulation in the absence of a legislative mandate.

Why Is Enhanced HFT Regulations Necessary?

- Because they are such a new phenomenon, HFTs, aren't even mentioned in Dodd/Frank. But as we saw in the Flash Crash of 2010, and in numerous events since then, "cheetahs" can move markets precipitously, and we need to ensure that their trading doesn't negatively affect the primary.

How Should HFTs Be Regulated?

- At a minimum, HFTs should be registered with a federal financial market regulator. If they aren't, regulators can't get a quick, comprehensive window into their trading. This is necessary a fundamental first step required to protect markets and consumers.

What Else Should Be Included in Federal HFT Oversight?

- Several basic oversight capabilities should be implemented, to ensure that federal regulators can effectively—and quickly—oversee this type of trading. At a minimum these authorities should include:
    - Testing of HFT trading programs
    - Kill Switches, in the event that an HFT trading program goes feral
    - Pre-Trade "Wash Blocker" Technology, to ensure that an HFT isn't creating "false liquidity" by trading with itself
    - Required Compliance Reporting, to ensure that HFTs are held accountable for any false or misleading information
    - Appropriate penalties (for example, "per second" violation fines, for "per second" type trading)

Targeted Transaction Fee (TTF) Proposal

It's time to consider adoption of a transaction fee on non-hedging transactions in derivatives markets, designed to result in approximately $300 million in funding. True end-users would not be assessed transaction fees.

Why is a TTF necessary?

- Derivatives markets in the U.S. are growing at a phenomenal rate, and, particularly with the growth of the CFTC's jurisdiction to include swaps markets, there is simply too much to effectively oversee on our current budget.
- The CFTC is the only federal financial regulator NOT to have some kind of self-funding.
- New technologies and trading methods (e.g., HFTs) have resulted in vastly increased volumes, and the CFTC needs more resources to appropriately oversee these markets.

How would a TTF be implemented?

- The agency could use existing authorities to assess transaction fees, or Congress could, in our upcoming reauthorization, mandate assessment of such fees.
- In developing the fee level, a paramount concern is to ensure that the markets' pricing and hedging functions are not impaired. Therefore, the tax would only be applied to non-hedging transactions, and must be set at a level that does not impair market liquidity.
- For example, using a futures volume of 20 million trades per day, an approximately non-hedging percentage of 95%, and an estimated 255 trading days per year, this would result in a per transaction fee of about .06 cents (six one-hundredths of a cent) on futures transactions. The fee level would be recalibrated (lowered) to include swaps transactions.

What should be included in a TTF?

- All derivatives transactions, including swaps, should be assessed transaction fees. Given the disparity in the volume between swaps and futures markets, different assessments would be required so as not to create an unlevel playing field.
- This would have the two-fold benefit of 1) providing necessary funding to the Commission to adequately oversee the markets, and 2) deter folks from entering into flash-in-the-pan, non-bona-fide trading.

WASHINGTON PUBLIC UTILITY DISTRICTS ASSOCIATION
WPUDA
YOUR connection

212 Union Ave., Ste 201
Olympia, WA 98501
(360) 741-2675 *Main*
(360) 741-2686 *Fax*
www.wpuda.org

April 30, 2013

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

The Honorable Thad Cochran, Ranking Member
Committee on Agriculture, Nutrition and Forestry
United States Senate
328A Russell Senate Office Building
Washington, D.C. 20510

Dear Chair Stabenow and Ranking Member Cochran:

On behalf of the Washington Public Utility Districts Association I would like to thank you for the opportunity to provide comments as the Senate Agriculture Committee begins considering reauthorization of the Commodities Exchange Act. As part of your work, we encourage you to address damaging inconsistencies in the Commodity Futures Trading Commission's (CFTC) implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act regarding swap dealing activity with "special entities." These inconsistencies present costly barriers to public utility districts' hedging programs and could be remedied with a legislative fix in the reauthorization legislation.

The Washington Public Utility Districts Association (WPUDA) represents 27 not-for-profit, community-owned public utility districts that serve approximately one-million residential, business and industrial customers in 26 counties across the State of Washington. Municipal utilities, including WPUDA members, depend on nonfinancial commodity transactions, trade options, and "swaps," as well as the futures markets, to hedge commercial risks that arise from their utility facilities, operations, and public service obligations. In hedging, mitigating or managing operational risks, we are engaged in commercial risk management activities that are no different from the operations-related hedging of an investor-owned utility or an electric cooperative located in the same geographic region.

Rules regulating derivatives under Dodd-Frank have impacted PUDs' ability to hedge against price volatility, resulting in cost increases. Dodd-Frank directed the CFTC to require swap dealers and major swap participants to register and meet strict capital, margin, and reporting and recordkeeping requirements, as well as comply with rigorous business conduct and documentation standards. Congress was concerned that there be a distinction between these market-making entities and end-users that use swaps to hedge commercial risk.

To address those concerns, the Dodd-Frank Act included a "*de minimis* exception" to the definition of a swap dealer, to ensure that the definition captured only those entities engaged in a significant amount of dealing activity. In the proposed rule to define these entities, the CFTC set two separate *de minimis* thresholds relating to the dollar quantity of swaps; $100 million annually for an entity's total swap-dealing activity and $25 million annually for an entity's swap-dealing activity with special entities, which include government owned utilities.

The Not-For-Profit Electric End User Group (NFP EEU) filed comments recommending that the CFTC substantially increase both thresholds. Nevertheless, the final rule greatly increased the overall *de minimis* threshold from the proposed rule, raising it from $100 million to $3 billion, while leaving unchanged the $25 million sub-threshold for swap-dealing activities with special entities. The result is counterparties continue to fear that transacting with municipal utilities, including PUDs, will force them into the swap dealer regime. This has reduced the number of vendors willing to transact with PUDs thereby raising the cost of these transactions.

Our members are already seeing the impact. Benton County PUD, located in southeast Washington, had International Swaps and Derivatives Agreements (ISDAs) with 14 counterparties prior to Dodd-Frank. The PUD is now down to two counterparties. Another member, Grays Harbor County PUD, has also seen a dramatic decrease in the number of counterparties decrease from 28 to two. Fewer counterparties means less market liquidity and less favorable prices.

Unfortunately, efforts to obtain regulatory relief have been exhausted. On July 12, 2012, the American Public Power Association (APPA), the Large Public Power Council (LPPC), the American Public Gas Association (APGA), the Transmission Access Policy Study Group (TAPS), and the Bonneville Power Administration (BPA) filed a petition requesting that the CFTC amend its swap-dealer rule to exclude utility operations-related swap transactions from counting towards the special entity threshold.

Instead, the CFTC released a "no-action" letter allowing a counterparty to deal in up to $800 million in swaps with government-owned utilities without being required to register as a swap dealer. However, the no-action letter also included a number of additional limitations and has failed to provide nonfinancial counterparties with the assurances they need to enter into swap transactions with municipal utilities. Our traditional counterparties are unwilling to spend the time and money to create a separate compliance process, and adjust their policies and procedures, to facilitate transactions with the small segment of any particular regional market that utility special entities represent.

Several CFTC commissioners have indicated that they believe that relief is appropriate and, absent action by the CFTC, legislation to address this issue directly would be appropriate.

On March 11, 2013, Rep. Doug LaMalfa introduced the *"Public Power Risk Management Act of 2013"* (H.R. 1038). The legislation largely mirrors the intent and effect of the NFP EEU petition, providing narrowly targeted relief for operations-related swaps for government-owned utilities. Specifically, the legislation would provide that the CFTC, in making a determination to exempt a swap dealer under the *de minimis* exception, shall treat a utility operations-related swap with a utility special entity the same as a utility operations-related swaps with any entity that is not a special entity.

The legislation carefully defines which entities would qualify as a "utility special entity." It also specifically defines the types of swaps that could and could not be considered a "utility operations-related swap." For example, the legislation specifically prohibits interest, credit, equity, and currency swaps from being considered as a utility operations-related swap. Likewise, except in relation to their use as a fuel, commodity swaps in metal, agricultural, crude oil, or gasoline would not qualify either. Finally, the legislation also confirms that utility operations-related swaps are fully subject to swap reporting requirements.

When implemented, this legislation should provide certainty to nonfinancial entities that they can enter into swap transactions with community-owned utilities without fear of being deemed a swap dealer. **We strongly request that you support inclusion of this legislation as part of a CFTC reauthorization**.

Thank you again for the opportunity to submit comments. Please feel free to contact me if you require any additional information.

Sincerely,

Gy M. Caan

George Caan, Executive Director
Washington Public Utility Districts Association

MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

Recommendations for FSOC Members/Regulators
On the Protection of Non-public, Sensitive and Proprietary Information
May 2013

I. Introduction & Summary

Managed Funds Association[1] ("**MFA**") wishes to express concern to the Financial Stability Oversight Council ("**FSOC**") and its member agencies'[2] ("**Regulators**") regarding their protection of non-public, sensitive and proprietary information collected or shared as part of a Regulator's oversight of financial market participants and/or financial stability.[3] Regulators, in the course of discharging their various responsibilities under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank Act**"), are collecting an unprecedented level and quantity of non-public, sensitive and proprietary information concerning investment

[1] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

[2] FSOC Member Agencies are: the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Bureau of Consumer Financial Protection, the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, the Federal Housing Finance Agency, the National Credit Union Administration, the Office of Financial Research, and the Federal Insurance Office; as well as individual FSOC Members, such as the independent Presidential appointee, the designated state insurance commissioner, the designated state banking supervisor, and the designated state securities commissioner.

Our recommendations herein on the protection of non-public, sensitive and proprietary information apply to all FSOC member and member agencies, voting and non-voting members alike to the extent a member or member agency receives non-public, sensitive and proprietary information. For example, the Director of the Office of Financial Research ("**OFR**") is a non-voting member, but as OFR is in a position to access and even collect sensitive and proprietary information it must ensure that it is protecting sensitive and proprietary information as fully as possible.

[3] *See, e.g.*, Audit of the Financial Stability Oversight Council's Controls over Non-public Information, The Council of Inspectors General on Financial Oversight, June 2012; Semiannual Report for CFTC, CFTC Office of Inspector General, Oct. 31, 2012; SEC's Controls over Sensitive/Nonpublic Information Collected and Exchanged with the Financial Stability Oversight Council and Office of Financial Research, SEC Office of Inspector General, Mar. 25, 2013; 2012 FISMA Executive Summary Report, SEC Office of Inspector General, Mar. 29, 2013; *Academic Use of CFTC's Private Derivatives Data Investigated*, Bloomberg, Mar. 7 2013; *CME Group sparked shutdown of CFTC's academic research program*, Reuters, April 24, 2013; and *SEC needs better controls to protect data – watchdog*, Reuters, Apr. 3, 2013.

strategies from market participants.[4] MFA broadly supports such data collection efforts to inform policy making, but believe FSOC and Regulators need to ensure that they are protecting the data as fully as possible.

Market participants invest significant research, time and resources into developing proprietary investment strategies. Such investment strategies are trade secrets, protected by law. The Dodd-Frank Act, like other statutes,[5] recognizes the legitimate commercial need to protect the confidentiality of such secrets; and sets forth confidentiality and information-sharing provisions among the Regulators. We also believe that as a matter of financial stability, it is important for Regulators to maintain the confidentiality of market participants' trade data and investment strategies. We are concerned that if FSOC or Regulators disclose sensitive or proprietary information relating to an investment firm's portfolio or investment, recipients could use such information to trade against the investment firm and cause, especially during times of market stress or financial stress for the investment firm, further market or financial stress, and even the potential liquidation of such firm's fund or positions. Moreover, recipients of such information might be able to employ the data in ways that could be harmful more broadly.

In light of recent inspector general reports, press reports and Regulators' new Dodd-Frank Act authorities and information-sharing duties and obligations, MFA believes it is appropriate and necessary for Regulators to review their existing policies, practices and controls now before either a Regulator inadvertently leaks information or a hacker perpetrates a malicious attack. We urge FSOC and the Regulators to coordinate such a review of practices and controls with fellow FSOC members and to address any necessary concerns or weakness that the review reveals.[6] To that end, MFA has developed a number of recommendations for the Commodity Futures Trading Commission ("**CFTC**") and the Securities and Exchange Commission ("**SEC**", with the CFTC, the "**Commissions**"), as the primary regulators of investment advisers/pool operators and their funds, and the FSOC and its members, as the collective financial stability regulators, to strengthen policies and controls around the protection of non-public information. While we address certain recommendations to the Commissions in response to specific events, we believe the recommendations may be broadly applicable to Regulators.

Discussed in detail below, MFA makes the following recommendations:

1. MFA recommends that the Commissions review and harmonize policies and controls concerning the treatment of sensitive and proprietary information.

---

[4] *See* Section 112 of the Dodd-Frank Act (requiring the FSOC to collect information from member agencies to assess systemic risk). MFA supported enhanced information reporting during the legislative process that resulted in the enactment of the Dodd-Frank Act. *See* Testimony of the Honorable Richard H. Baker, before the Committee on Financial Services, U.S. House of Representatives, October 29, 2009, available at: http://www.managedfunds.org/downloads/MFA%20Written%20Testimony.pdf.

[5] *See e.g.*, Freedom of Information Act, 5 USC §552 (b)(4) (hereinafter "FOIA") (exception for "trade secrets and commercial or financial information obtained from a person and privileged or confidential....").

[6] *See* Section 112 of the Dodd-Frank Act. *See supra* n. 2.

2. MFA recommends that Regulators review the robustness of their policies, practices and controls relating to their use and treatment of sensitive and proprietary information and adopt such enhancements as are necessary.

3. MFA recommends that Regulators heighten staff sensitivity and awareness on the handling of non-public, sensitive and proprietary information through annual trainings and certifications, and regular reminders.

4. MFA recommends that FSOC Member Agencies implement a uniform system for sharing and protecting non-public information; such uniform system should include detailed controls and procedures around the access, documentation and use of non-public information, and be tailored appropriately for the level of sensitivity of the information.

5. MFA recommends that the Commissions require and confirm that Data Repositories and other regulated entities maintain robust policies, practices and controls to protect the confidentiality of sensitive and proprietary information, including the identity of traders and the nature of their trading activities.

II. Preventing the Misuse of Sensitive and Proprietary Information

A. Harmonizing Policies and Controls at the CFTC and SEC

MFA believes that the Commissions should harmonize their policies and controls around the treatment of private, sensitive data collected for regulatory purposes as fully as possible. The Commissions share the most overlap of regulated entities and policies, and as a result, have the greatest need for cooperation. We recognize that there are discrepancies between the Commodity Exchange Act ("**CEA**") and the securities laws with respect to the treatment of non-public, sensitive and proprietary data, information and/or materials (referred to herein as "sensitive and proprietary information"). Nevertheless, these federal laws share an objective, *i.e.*, the protection of sensitive and proprietary information. As the Commissions are both regularly in receipt of sensitive trade data, and collect substantially the same information from investment advisers, commodity pool operators and commodity trading advisors; and foreseeably will be collaborating in investigations (*i.e.*, the CFTC and SEC staffs' joint report on the May 6, 2010 market event[7]) and sharing and exchanging sensitive and proprietary information, we believe the Commissions should harmonize their policies and controls with respect to the treatment of sensitive and proprietary information.

Generally, although not exclusively, the Commissions receive sensitive and proprietary information of investment advisers, commodity pool operators ("**CPOs**"), commodity trading advisors ("**CTAs**") and their funds from the following sources: trade data from self-regulatory organizations, intermediaries and other regulated entities (*i.e.*, broker-dealers, futures commission merchants, swap data repositories and clearinghouses); new systemic risk reports

---

[7] *See* Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, *Findings Regarding the Market Events of May 6, 2010*, September 30, 2010, available at: http://www.cftc.gov/ucm/groups/public/@otherif/documents/ifdocs/staff-findings050610.pdf.

(*i.e.*, Forms PF, CPO-PQR, and CTA-PR); and examinations. Regardless of how the Commissions obtain the sensitive and proprietary information, we believe that the Commissions must have robust policies and controls to protect such information in accordance with law.[8]

Congress has directed both Commissions to protect confidential information. Section 8(a) of the CEA provides that the CFTC "may not publish data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers."[9] (*See* **Appendix A** for the full language.)

Similarly, Section 24(b) of the Securities Exchange Act of 1934 ("**Exchange Act**") provides that a "member, officer, or employee" of the SEC is prohibited from "disclos[ing] to any person other than a member, officer, or employee of the [SEC], or to use for personal benefit, any information" protected under section 552 of Title 5 of the U.S. Code or SEC regulations.[10] Section 204(b) of the Investment Advisers Act of 1940 ("**Advisers Act**") provides that "any proprietary information of an investment adviser ascertained by the [SEC] from any report required to be filed with the [SEC] . . . shall be subject to the same limitations on public disclosure as any facts ascertained during an examination;"[11] and that any other regulatory entity that receives such proprietary information from the SEC "shall maintain the confidentiality of such reports, documents, records, and information in a manner consistent with the level of confidentiality established" by the SEC.[12] (See **Appendix A** for the full language.)

Pursuant to Sections 112 and 404 of the Dodd-Frank Act and Section 1a of the CEA, the Commissions adopted new rules requiring SEC-registered investment advisers, and CFTC-registered CPOs and CTAs to file systemic risk reports—respectively, Form PF, Form CPO-PQR, and Form CTA-PR (together "**Systemic Risk Reports**").[13] The Commissions allow a registrant that is both an SEC-registered investment adviser and a CFTC-registered CPO or CTA to file Form PF to satisfy as "substituted compliance" certain filing obligations under Form CPO-PQR and CTA-PR.[14]

We believe it makes practical sense for the Commissions to harmonize their policies and controls around the treatment of sensitive and proprietary information for several reasons. First, in order for the CFTC to receive proprietary investment adviser information from the SEC, the

---

[8] *See* Section 8(a) of the Commodity Exchange Act ("CEA"); Section 24 of the Securities Exchange Act of 1934 ("Exchange Act"); Section 204 of the Investment Advisers Act of 1940 ("Advisers Act"); FOIA *supra* n. 5; and Section 112(b)(5) of the Dodd-Frank Act.

[9] Section 8(a)(1) of the CEA.

[10] Section 24 of the Exchange Act. *See also*, FOIA *supra* n. 5.

[11] Section 204(b)(10) of the Advisers Act.

[12] Section 204(b)(9) of the Advisers Act.

[13] *See* 76 Fed.Reg. 71128 (Nov. 16, 2011), Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, available at: http://www.gpo.gov/fdsys/pkg/FR-2011-11-16/pdf/2011-28549.pdf; and 77 Fed. Reg. 11252 (Feb. 24, 2012), Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, available at: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-3390a.pdf.

[14] *See id.*

Dodd-Frank Act requires that the receiving agency must maintain the confidentiality of such information in a manner consistent with the level of confidentiality established at the SEC.[15] To do so, the CFTC must have comparable policies and controls in place as the SEC to protect confidential information. Nevertheless, to the extent the CFTC receives freedom of information requests with respect to sensitive and proprietary information it has received from the SEC, we believe the CFTC as the receiving agency should defer to the SEC on its policies and procedures. Second, as the markets the Commissions oversee become ever more intertwined, it is reasonably foreseeable that the Commissions will engage in a greater number of joint investigations, and frequent sharing of sensitive and proprietary information. Finally, we believe that if the Commissions harmonize their policies and controls on the treatment of sensitive and proprietary information, it may reduce the likelihood of inadvertent disclosures of sensitive and proprietary information. Accordingly, we recommend that the Commissions review and harmonize policies and controls around the treatment of sensitive and proprietary information.

Recommendation: MFA recommends that the Commissions review and harmonize policies and controls concerning the treatment of sensitive and proprietary information.

B. Enhancing Policies and Controls to Protect Sensitive and Proprietary Information

MFA believes that the Commissions should update and enhance the robustness of their policies, practices and controls around the use and treatment of sensitive and proprietary information. The Dodd-Frank Act bestows upon the Commissions, in their new role to oversee financial stability, new authorities to collect and share information.[16] As the Commissions are collecting on a routine basis an unprecedented level of sensitive and proprietary information, we believe they need to ensure that they have robust policies and controls around the collection and handling of sensitive and proprietary information (*e.g.*, Forms PF, CPO-PQR and CTA-PR). We are concerned from recent press and inspector general reports that the Commissions do not have adequate policies, practices and controls to protect the confidentiality of sensitive and proprietary information.

The Commissions require investment advisers, CPOs and CTAs to file Systemic Risk Reports.[17] These reports require Registrants to report highly sensitive and proprietary information relating to their businesses through these Systemic Risk Reports, including investment holdings. As discussed above, Section 8(a) of the CEA and Section 204(b) of the Advisers Act require that the Commissions protect the confidentiality of an investment adviser's, CPO's and CTA's sensitive and proprietary information.[18]

---

[15] Section 404 of the Dodd-Frank Act (amending Section 204(b) of the Advisers Act).

[16] Section 112 of the Dodd-Frank Act

[17] *See supra* n. 13.

[18] *See supra* n. 9-12 and corresponding text.

We are extremely concerned with recent findings in the SEC Inspector General report on "controls over sensitive/nonpublic information collected and exchanged with the FSOC and OFR" (**"Report on Controls over Sensitive/Nonpublic Information"**).[19] The Report on Controls over Sensitive/Nonpublic Information concludes that the SEC has insufficient controls to protect the data collected through the Form PF process. Specifically, it found that: (1) the lack of remote access controls may put sensitive and nonpublic information at risk of unauthorized disclosure;[20] (2) the SEC's protocol for inventorying, tracking, and marking information collected by and exchanged with FSOC, its Member Agencies, and OFR needs improvement;[21] and (3) new contractors are not provided training on handling sensitive and nonpublic information in a timely manner.[22]

Similarly, we are extremely troubled and alarmed by recent press reports alleging that CFTC staff and outside researchers used sensitive and proprietary information and published independent research papers based on that information that were not sanctioned by the CFTC.[23] First, as such data is protected from disclosure by law we are concerned that non-CFTC staff had access to it.[24] Second, we are concerned that certain CFTC staff and non-CFTC staff may have reverse-engineered certain trading strategies and published information that should be regarded as trade secrets, business transactions or commercial or financial information. Even though the research papers did not reveal the identities of traders, they revealed trade secrets and commercial or financial information in direct violation of federal laws.[25] Also, the research papers seem to indicate that the researchers had access to proprietary information that they could have used for other purposes, such as trading against a market participant (*e.g.*, front running) or "cloning" a market participant's profitable trading strategies. Finally, we are concerned that papers based on highly sensitive and confidential information were not submitted to the CFTC Commission members or separate staff for approval prior to publication.

We strongly believe that the Commissions need to have comprehensive internal policies and controls implementing the mandates of the federal statutes mentioned above, to prohibit and

---

[19] *See* SEC's Controls over Sensitive/Nonpublic Information Collected and Exchanged with the Financial Stability Oversight Council and Office of Financial Research, SEC Office of Inspector General, Mar. 25, 2013.

[20] The Report on Controls over Sensitive/Nonpublic Information found that SEC employees and contractors remotely accessing SEC's email system are not restricted from saving and uploading sensitive or nonpublic information on non-SEC computers.

[21] The Report on Controls over Sensitive/Nonpublic Information found that the SEC had not appointed a primary information owner to oversee information the SEC receives and shares with FSOC, its Member Agencies, or OFR; and that a protocol for inventorying and ensuring that information is appropriately marked had not been fully developed.

[22] The Report on Controls over Sensitive/Nonpublic Information found that newly assigned contractors working with FSOC, its Member Agencies, and the OFR information are not promptly and adequately trained on how to handle sensitive or nonpublic information.

[23] *See, e.g.,* Adam Clark-Joseph, *Exploratory Trading*, January 13, 2013. *See also,* Andrei Kirilenko et al., *The Flash Crash: The Impact of High Frequency Trading on an Electronic Market*, May 26, 2011; and Jaksa Cvitanic and Andrei Kirilenko, *High Frequency Traders and Asset Prices*, March 11, 2010.

[24] *See* Section 8(a) of the Commodity Exchange Act.

[25] *See supra* n. 23 and *supra* n. 8.

prevent the misuse or disclosure of sensitive and proprietary information. The Commissions should consider such policies and controls in conjunction with their requirements under the Federal Information Security Management Act of 2002[26] ("**FISMA**"), and the standards set by the National Institute of Standards and Technology ("**NIST**") in connection with FISMA.[27] (See **Appendix B** for NIST criteria for an effective information security program.) We believe NIST Special Publication 800-53 sets forth a very useful set of security and privacy controls, specifically developed to help protect federal information systems and organizations.[28] We recommend that the Commissions consider the latest standards set forth by NIST in revising its internal policies, practices and controls around sensitive and proprietary information.

At a minimum, such policies and controls to prevent the disclosure of non-public information should outline appropriate use of sensitive and proprietary information and prohibit the publication of any report that has the potential of exposing the identity of specific market participants, or that would harm market participants or legitimate trading strategies even without disclosure of the identities of such market participants. Examples of the types of policies and controls that the Commissions should include, but are not limited to policies and controls that:

- Limit internal access to sensitive and proprietary information to relevant staff and employees;
- Log staff/employee and contractor access to databases with sensitive and proprietary information;
- Password protect files with sensitive information;
- Monitor when data is downloaded or transferred;
- Restrict the ability to download, transfer or save sensitive non-public information to a non-government computer, storage device or portable or removable media;
- Require periodic testing and evaluation of the effectiveness of information security policies, procedures, practices, and security controls to be performed with a frequency depending on risk, but no less than annually;[29]
- Implement procedures for detecting, reporting (*i.e.*, to the owner of the information), and responding to the improper use of nonpublic information;
- Implement a process for planning, implementing, evaluating, and documenting remedial actions to address any deficiencies in the information security policies, procedures, and practices of the organization;[30]
- Require periodic third party testing and evaluation of policies, practices and controls around the protection of sensitive and proprietary information; and

[26] Title III of the E-Government Act of 2002, Pub. L. 107-347 (2002) (recognizing the importance of information security to the economic and national security interests of the United States). FISMA requires each federal agency to develop, document, and implement an agency-wide program to provide information security for the information and information systems that support the operations and assets of the agency.

[27] *See* FISMA Implementation Project on the NIST website, available at: http://csrc.nist.gov/groups/SMA/fisma/index.html.

[28] *See* Security and Privacy Controls for Federal Information Systems and Organizations, NIST Special Publication 800-53 (April 2013), available at: http://nvlpubs.nist.gov/nistpubs/SpecialPublications/NIST.SP.800-53r4.pdf.

[29] This is a NIST recommendation for an effective security program. *See id.*

[30] This is a NIST recommendation for an effective security program. *See id.*

- Impose disciplinary action for improper use of confidential data.

We believe the Commissions should also consider retaining an outside expert in data security to work with staff to design robust protections and internal controls.

In general, we are wary of the Commissions providing third parties, including consultants and academic researchers, access to confidential data or materials from which market participants may be identified or their strategies revealed. Even with non-disclosure agreements in place, we believe it can be challenging to monitor whether third parties abide by such agreements and do not misappropriate or use any information for improper purposes. Congress authorized the Commissions to collect sensitive and proprietary information "as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk."[31] Accordingly, we believe such sensitive and proprietary information should only be used for essential regulatory oversight functions. To the extent that the Commissions provide third parties with access to confidential materials, including the ability to read or study such materials, we believe they should have robust policies and controls in place, which at a minimum:

- Require a third party to sign a confidentiality and non-disclosure agreement;
- Limit and control the information provided to a third party;
- Specifically outlines the purpose and scope of allowed use of the materials;
- Document all persons with access to sensitive and proprietary information and the reason for their access to such information;
- Limit the use of sensitive and proprietary information for purposes that are in the public interest and for the protection of investors or for the assessment of systemic risk;
- Require a cost-benefit assessment, and documentation of such assessment, when sensitive and proprietary information is used for the purposes of a "study";
- Require Commission approval for the publication of a study based on sensitive and confidential information;
- Mask the identity of market participants or remove identifying information;
- Control access to the confidential information;
- Implement a mechanism for reporting the improper use of sensitive and proprietary information; and
- Impose disciplinary action for improper use of sensitive and proprietary information.

We also respectfully urge the Regulators to examine their protections against third party "hack" attacks. President Obama has declared cyber threat as one of the most serious economic and national security challenges, directing a full review of the Federal Government's efforts to defend its information and communications infrastructure.[32] Similarly, Department of Treasury officials have spoken of the Department's concerns with cyber-attacks on the Federal

[31] *See* Section 204(b) of the Advisers Act. *See also* Section 8(a) of the CEA (providing that the CFTC "may publish from time to time the results of . . . such general statistical information gathered therefrom as it deems of interest to the public" provided that it doesn't disclose trade secrets).

[32] Remarks by the President on Securing Our Nation's Cyber Infrastructure, The White House, May 29, 2009, available at: http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Securing-Our-Nations-Cyber-Infrastructure.

Government and key financial institutions.[33] Regulators must secure vital, proprietary information they receive from market participants from such cyber security attacks. The Regulators correctly impose obligations on market participants, such as the recent identity theft rules, to protect sensitive investor and client information.[34] Similarly, Regulators should have protections in place to secure sensitive and proprietary information they receive from registrants and market participants to protect investor and client information.

Of course, as a private sector entity, MFA has no specific knowledge of Regulators' existing capabilities to protect against cyber-attacks. We presume that the Regulators are well aware of these threats and have taken meaningful action to protect the information that they hold. Nonetheless, with the ever increasing threat of hacking and other illegal behavior in addition to Regulators' increasing demand for sensitive and proprietary data from market participants, we believe it is important to ensure that the Regulators are taking all reasonable precautions. Accordingly, we recommend that Regulators review the robustness of their policies, practices and controls relating to their use and treatment of sensitive and proprietary information and adopt such enhancements as are necessary.

Recommendation: MFA recommends that Regulators review the robustness of their policies, practices and controls relating to their use and treatment of sensitive and proprietary information and adopt such enhancements as are necessary.

C. Staff Training on Policies and Controls

MFA believes that Regulators should require annual security awareness training to inform personnel of the information security risks associated with their activities and their responsibilities in complying with organizational policies and procedures designed to reduce these risks.[35] MFA presumes that Regulators have general policies and procedures in place with respect to handling non-public information, including information learned in the ordinary course of performing regulatory functions. Pursuant to rulemaking implementing the Dodd-Frank Act, we believe many new personnel at Regulators may now have responsibility working with sensitive and proprietary information—information that should be held to a higher level of protection and restriction than simply non-public information learned in the ordinary course of business. For example, we believe that staff in rulemaking offices or divisions, or staff assigned to FSOC projects, who previously may not have worked with sensitive and proprietary information, should be trained and certified on policies and controls around sensitive and

---

[33] *See* U.S. Presses on Cyberthreats, W.S.J., March 20, 2013, available at: http://online.wsj.com/article/SB10001424127887324373204578372132763639230.html; Remarks of Secretary Jacob J. Lew at Johns Hopkins University School of Advanced International Studies, April 17, 2013, available at: http://www.treasury.gov/press-center/press-releases/Pages/jl1899.aspx. *See also* FSOC 2013 Annual Report, April 25, 2013, available at: http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202013%20Annual%20Report.pdf.

[34] 78 Fed.Reg. 23638 (April 19, 2013), Identity Theft Red Flags Rule, available at: http://www.gpo.gov/fdsys/pkg/FR-2013-04-19/pdf/2013-08830.pdf (requiring certain SEC or CFTC registrants to implement identity theft red flags policies and procedures).

[35] *See* **Appendix** B for NIST recommendations for an effective security program.

proprietary information prior to assuming regulatory responsibilities involving sensitive and proprietary information. If not currently doing so, we recommend that Regulators heighten staff sensitivity and awareness on the handling of sensitive and proprietary information through annual trainings and certifications, and regular reminders.

Recommendation: MFA recommends that Regulators heighten staff sensitivity and awareness on the handling of non-public, sensitive and proprietary information through annual trainings and certifications, and regular reminders.

D. Coordinating Policies and Controls Among FSOC Member Agencies

MFA believes that FSOC Member Agencies should review and coordinate their policies, practices and controls around the sharing of sensitive and proprietary information. We are concerned that differences in policies and practices at FSOC Member Agencies may lead to the inadvertent disclosure of sensitive and proprietary information. Further, we believe that coordinated policies and practices around the sharing of sensitive and proprietary information will help strengthen controls at FSOC Member Agencies and OFR.

The Dodd-Frank Act requires members of FSOC to "collect information from member agencies . . . to assess risks to the United States financial system"[36] as well as to "maintain the confidentiality of any data, information, and reports" received pursuant to the Financial Stability Act.[37] While members of FSOC have each signed the *Memorandum of Understanding Regarding the Treatment of Non-public Information Shared Among Parties Pursuant to the Dodd-Frank Act*, we are concerned that differences in each member's policies and controls may lead to inadvertent breaches of information security.[38]

For example, the Council of Inspectors General on Financial Oversight ("**CIGFO**") found that FSOC members have different marking systems for designating non-public information and different controls for handling non-public information.[39] We support CIGFO's suggestion that FSOC Member Agencies "further examine the issues raised in [CIGFO's audit report of FSOC] to increase their understanding of the differences in members' information control environments" and develop best practices.[40] We also agree on the importance of FSOC members acting in a timely manner with regard to developing tools for secure collaboration and controlled access to data shared among FSOC members, considering the potential heightened impact designation of new information and the control ramifications of decisions made about such information.[41]

---

[36] Section 112(a)(2) of the Dodd-Frank Act.

[37] Section 112(d)(5) of the Dodd-Frank Act.

[38] *See, e.g., Audit of the Financial Stability Oversight Council's Controls over Non-public Information*, Report to FSOC and the Congress, prepared by The Council of Inspectors General on Financial Oversight (June 2012).

[39] *See id.*

[40] *Id.*

[41] *Id.*

We recommend that FSOC Member Agencies implement a uniform system for sharing and protecting non-public information. Such uniform system should include detailed controls and procedures around the access, documentation and use of non-public information (*see, e.g.*, section I.B. above); and tailored appropriately for the level of sensitivity of the information. While our specific discussion in section I.B. was directed at the Commissions, we believe the recommendations are relevant for all FSOC Member Agencies, especially as the Advisers Act requires any other regulatory entity that receives investment adviser reports to maintain the confidentiality of such reports in a manner consistent with the SEC.[42] We commend CIGFO for creating a working group to evaluate FSOC controls over non-public information and the manner in which FSOC and Member Agencies safeguard information from unauthorized disclosure.[43] We believe this working group will be very helpful in enhancing FSOC and its members' policies and controls with respect to non-public information.

Recommendation: MFA recommends that FSOC Member Agencies implement a uniform system for sharing and protecting non-public information; such uniform system should include detailed controls and procedures around the access, documentation and use of non-public information, and be tailored appropriately for the level of sensitivity of the information.

III. Protecting Sensitive & Proprietary Information at Regulated Entities

We believe that the Commissions should clarify that under final rules relating to swap data repositories ("**SDRs**") and security-based swap data repositories ("**SBSDRs**") (together, "**Data Repositories**"), Data Repositories, as part of their obligations to maintain the privacy of transaction information,[44] must have robust policies and controls to protect both the identity of traders and sensitive and proprietary information. We believe the Commissions should also remind other industry market utilities, such as self-regulatory organizations, designated contract markets, designated clearing organizations or clearinghouses ("**Regulated Entities**"), of their obligation to maintain the privacy of transaction information. Specifically, we would like to ensure that as new Data Repositories establish their policies, practices and controls, they and Regulated Entities implement robust confidentiality protections that: (1) protect counterparty anonymity for transactions at all times;[45] and (2) protect against inadvertent disclosure of trade data. We respectfully urge the Commissions in their oversight roles to review the policies,

---

[42] *See supra* n. 12 and corresponding text. We note that the SEC requests for comments on proposed rules concerning the sharing of security-based swap data by a SBSDR and a foreign regulatory entity. *See* Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 34-69490 (May 1, 2013). We believe that the SEC and/or the SBSDR, prior to providing a foreign regulatory entity with security-based swap data, should seek assurances that such foreign regulatory entity will maintain the confidentiality of such data in a manner consistent with the SEC and/or SBSDR.

[43] Annual Report of the Council of Inspectors General on Financial Oversight, July 2012.

[44] *See, e.g.*, Sections 728 and 763(i) of the Dodd-Frank Act.

[45] *See* letter from Stuart J. Kaswell, Executive Vice President & Managing Director, MFA, to Richard A. Shilts, Director, CFTC, dated February 28, 2013, regarding a "Request for Interpretive Guidance – Swap Counterparty Access to Legal Entity Identifiers in SDR Data and Information."

practices and controls at Data Repositories with respect to the protection of sensitive and proprietary information.

Regarding the protection of counterparty anonymity, we understand, for example, that as an exception to the requirement to protect the confidentiality of reported swap data, an SDR may provide a party to a particular swap access to "data and information" related to such swap.[46] While "data and information" have not been defined, we believe CFTC and SEC regulations a should strictly prohibit a Data Repository from disclosing information to other market participants that would reveal the identity of traders, including through legal entity identifiers or other information, products traded, or the nature of their trading activities.

A key element to ensuring the market's confidence is to ensure that Data Repositories have robust systems and processes for the protection of confidential data. We are concerned by recent instances where a data repository inadvertently exposed confidential trade data. It is important for Data Repositories to implement appropriate policies and controls to prevent the inadvertent disclosure of sensitive and proprietary information. Such policies should also include protocols to mitigate and contain the harm when confidential information is disclosed and certain escalation and reporting procedures whereby the Data Repositories would immediately notify regulators and affected market participants. Furthermore, Data Repositories need policies and procedures to ensure that other market participants cannot trade upon the basis of exposed confidential trade data. A third party with improper access could trade against a firm or use the data to reverse-engineer and clone trading strategies. Thus, robust systems and controls at Data Repositories and Regulated Entities are necessary to protect investors and promote market integrity.

MFA believes that Data Repositories and Regulated Entities must provide appropriate safeguards to ensure the confidentiality of sensitive and proprietary information, particularly under circumstances in which regulations require market participants to furnish such data to Data Repositories, self-regulatory organizations, designated contract markets, designated clearing organizations or clearinghouses, among others. Accordingly, we respectfully urge the Commissions to require and confirm that Data Repositories and other regulated entities maintain robust policies, practices and controls to protect the confidentiality of sensitive and proprietary information, including the identity of traders and the nature of their trading activities.

Recommendation: MFA recommends that the Commissions require and confirm that Data Repositories and other regulated entities maintain robust policies, practices and controls to protect the confidentiality of sensitive and proprietary information, including the identity of traders and the nature of their trading activities.

IV. Conclusion & Recommendations

MFA has consistently supported reasonable reporting requirements to ensure that regulators have meaningful data upon which to make policy decisions. Strong confidentiality

[46] CFTC Final Rule on "Swap Data Repositories: Registration Standards, Duties and Core Principles", 76 Fed. Reg. 54538 (Sept. 1, 2011), available at: http://www.gpo.gov/fdsys/pkg/FR-2011-09-01/pdf/2011-20817.pdf.

protections help foster an atmosphere of trust to ensure that reporting entities are as forthcoming as possible while safeguarding investors and promoting market integrity. Accordingly, we make a number of recommendations:

Recommendation 1: MFA recommends that the Commissions review and harmonize policies and controls concerning the treatment of sensitive and proprietary information.

Recommendation 2: MFA recommends that Regulators review the robustness of their policies, practices and controls relating to their use and treatment of sensitive and proprietary information and adopt such enhancements as are necessary.

Recommendation 3: MFA recommends that Regulators heighten staff sensitivity and awareness on the handling of non-public, sensitive and proprietary information through annual trainings and certifications, and regular reminders.

Recommendation 4: MFA recommends that FSOC Member Agencies implement a uniform system for sharing and protecting non-public information; such uniform system should include detailed controls and procedures around the access, documentation and use of non-public information, and be tailored appropriately for the level of sensitivity of the information.

Recommendation 5: MFA recommends that the Commissions require and confirm that Data Repositories and other regulated entities maintain robust policies, practices and controls to protect the confidentiality of sensitive and proprietary information, including the identity of traders and the nature of their trading activities.

Appendix A

Section 8(a) of the CEA provides:

For the efficient execution of the provisions of [the CEA], and in order to provide information for the use of Congress, the [CFTC] may make such investigations as it deems necessary to ascertain the facts regarding the operations of boards of trade and other persons subject to the provisions of this Act. The [CFTC] may publish from time to time the results of any such investigation and such general statistical information gathered therefrom as it deems of interest to the public: *Provided,* That except as otherwise specifically authorized in this Act, ***the [CFTC] may not publish data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers*** . . . **(emphasis added).**[47]

Section 24(b) of the Exchange Act provides:

(b) It shall be unlawful for any member, officer, or employee of the Commission to disclose to any person other than a member, officer, or employee of the Commission, or to use for personal benefit, any information contained in any application, statement, report, contract, correspondence, notice, or other document filed with or otherwise obtained by the Commission (1) in contravention of the rules and regulations of the Commission under section 552 of Title 5, United States Code, or (2) in circumstances where the Commission has determined pursuant to such rules to accord confidential treatment to such information.

Section 204(b) of the Advisers Act provides:

(8) COMMISSION CONFIDENTIALITY OF REPORTS.—Notwithstanding any other provision of law, the Commission may not be compelled to disclose any report or information contained therein required to be filed with the Commission under this subsection, except that nothing in this subsection authorizes the Commission—
(A) to withhold information from Congress, upon an agreement of confidentiality; or
(B) prevent the Commission from complying with—
(i) a request for information from any other Federal department or agency or any self-regulatory organization requesting the report or information for purposes within the scope of its jurisdiction; or
(ii) an order of a court of the United States in an action brought by the United States or the Commission.
(9) OTHER RECIPIENTS CONFIDENTIALITY.—Any department, agency, or self-regulatory organization that receives reports or information from the Commission under this subsection shall maintain the confidentiality of such reports, documents, records, and information in a manner consistent with the level of confidentiality established for the Commission under paragraph (8).
(10) PUBLIC INFORMATION EXCEPTION.—

47

(A) IN GENERAL.—The Commission, the Council, and any other department, agency, or self-regulatory organization that receives information, reports, documents, records, or information from the Commission under this subsection, shall be exempt from the provisions of section 552 of title 5, United States Code, with respect to any such report, document, record, or information. Any proprietary information of an investment adviser ascertained by the Commission from any report required to be filed with the Commission pursuant to this subsection shall be subject to the same limitations on public disclosure as any facts ascertained during an examination, as provided by section 210(b) of this title.

(B) PROPRIETARY INFORMATION.—For purposes of this paragraph, proprietary information includes sensitive, non-public information regarding—

(i) the investment or trading strategies of the investment adviser;

(ii) analytical or research methodologies;

(iii) trading data;

(iv) computer hardware or software containing intellectual property; and

(v) any additional information that the Commission determines to be proprietary.

Appendix B

The National Institute of Standards and Technology provides that an effective information security program should include:

- Periodic assessments of risk, including the magnitude of harm that could result from the unauthorized access, use, disclosure, disruption, modification, or destruction of information and information systems that support the operations and assets of the organization.
- Policies and procedures that are based on risk assessments, cost-effectively reduce information security risks to an acceptable level, and ensure that information security is addressed throughout the life cycle of each organizational information system.
- Subordinate plans for providing adequate information security for networks, facilities, information systems, or groups of information systems, as appropriate.
- Security awareness training to inform personnel (including contractors and other users of information systems that support the operations and assets of the organization) of the information security risks associated with their activities and their responsibilities in complying with organizational policies and procedures designed to reduce these risks.
- Periodic testing and evaluation of the effectiveness of information security policies, procedures, practices, and security controls to be performed with a frequency depending on risk, but no less than annually.
- A process for planning, implementing, evaluating, and documenting remedial actions to address any deficiencies in the information security policies, procedures, and practices of the organization.
- Procedures for detecting, reporting, and responding to security incidents
- Plans and procedures to ensure continuity of operations for information systems that support the operations and assets of the organization.

More information on NIST information security standards is available at: http://csrc.nist.gov/groups/SMA/fisma/overview.html.

CME Group

11 June 2013

Patrick Pearson
Head of Unit, Market Infrastructure
European Commission
BERL 10/034
B - 1049 Brussels
Belgium

Re: Considerations Regarding the Equivalence Decision and Recognition as a Third-Country CCP under Articles 25 EMIR

Dear Mr. Pearson:

CME Group Inc. ("CME Group") is the parent of Chicago Mercantile Exchange Inc. ("CME") and its clearing division ("CME Clearing"). CME Clearing is one of the largest central counterparty ("CCP") clearing services for regulated derivatives contracts. CME offers clearing and settlement services for exchange-traded derivatives contracts and for over-the-counter ("OTC") derivatives transactions, including interest rate swaps, credit default swaps, agricultural swaps, and other OTC contracts. A significant portion of the exchange-traded positions cleared by CME are executed in Europe. For example, over the last year, nearly 16.5% of total screen trading came from Europe, which represents nearly 20% of total CME Group revenue from screen trading. Our OTC clearing solutions will also clear bilateral trades in which one or more counterparty is located within the European Union ("EU").

CME Clearing is registered with the U.S. Commodity Futures Trading Commission ("CFTC") as a derivatives clearing organization ("DCO") and a registered clearing agency with the Securities and Exchange Commission ("SEC"). CME Clearing has operated as a recognised overseas clearing house ("ROCH") in the United Kingdom since June 2007. This recognition is currently administered by the Bank of England ("BOE"). CME Clearing intends to apply to the European Securities and Markets Authority ("ESMA") for recognition as a third-country CCP under the European Market Infrastructure Regulation ("EMIR"). Recognition under EMIR requires the European Commission ("EC") to find that the United States ("US") regulatory framework is "equivalent" to that under the EU rules, primarily EMIR.

We support the movement to a harmonized EU framework for recognition of third-country CCPs under EMIR. As we near the deadline for ESMA to provide technical advice to the EC on equivalence for the US and Japan, we appreciate the opportunity to provide our perspectives on this important decision and offer greater detail on the various components of the US legal and risk management framework covering CME Clearing. Our objective is to provide the EC, ESMA, and European regulators with a holistic, outcome-based perspective of the factors to consider in evaluating equivalence related to CCP regulation. We urge the EC to consider this comprehensive view of how CCPs manage risk and would draw its attention particularly to the commentary and illustration of the more dynamic aspects of risk mitigation that cannot be addressed through a line-by-line comparison of regulatory provisions.

Our note covers the following areas for your consideration:

I. Role and importance of outcome-based recognition in the new era of derivatives regulation
II. Mutual recognition of third-country CCPs
III. Background on the US legal and regulatory framework for CCPs
IV. Risk mitigation best practices for clearing houses
V. Futures Commission Merchant ("FCM") regulatory protections under US law
VI. Variance between key CCP regulatory requirements in the US and EU, and where applicable, how factors not specifically addressed in CCP regulations should guide the evaluation of the CCP's risk management framework.

I. The role and importance of outcome-based recognition

CME Group has long been a strong supporter of a global framework whereby jurisdictions have the authority to grant access to third-country markets under the concepts of equivalence and mutual recognition. CME Clearing is recognized or exempted from recognition in many jurisdictions outside of the US and permitted to provide clearing services in those jurisdictions pursuant to a recognition process. CME Clearing is currently seeking recognition in several additional jurisdictions in addition to applying for recognition under the new EMIR regime in the EU.

Mutual recognition facilitates cross-border transactions in our global marketplace by reducing the need to harmonize multiple, and sometimes conflicting, regulatory regimes and the duplicative procedural burdens resulting from concurrent application of these regimes. In addition, providing global CCPs with the ability to efficiently operate in multiple jurisdictions will help obviate the risk that end customers will be unable to access central clearing due to clearing member or CCP bandwidth constraints. The potential for such access issues could in turn frustrate the G20 commitment to move standardized, OTC transactions to a centrally cleared environment.

Many jurisdictions have made significant progress in implementing the G20 mandates for derivatives regulatory reform, including moving towards the implementation of the Principles for Financial Market Infrastructures ("PFMI") published by the joint work of the Committee on Payment and Settlement Systems ("CPSS") and the Technical Committee of the International Organization of Securities Commissions ("IOSCO"). The PFMIs are an important step to setting reinforced and strengthened international standards that should be used as important guideposts for CCP best practices, and the recognition of third-country clearing houses where those clearing houses are subject to comprehensive supervision and regulation by a competent regulator and information-sharing arrangements between competent national regulatory authorities are in place.

Standards imposed on third-country firms and markets should be consistent with the international standards, and literal "equivalence" with regulations in the local market should not be used as a barrier to entry. Any jurisdiction's equivalence test should be based on transparent, proportionate, fair and objective grounds. It must also recognize that other jurisdictions have different legal and regulatory structures, that market structures may be subject to different transparency standards and may also develop different liquidity dynamics, and that equivalence should be judged on an outcome-determinative basis. A line-by-line comparison of regulatory requirements in different jurisdictions will inevitably produce variances, but regulators should focus on whether the overall outcome of financial and risk safeguards meets the relevant international standards such as the PFMIs—which have been driven by the world's most developed market regulators, including those in the US and EU.

II. Mutual Recognition of Third-Country CCPs

The PFMIs set standards for responsibilities of central banks, market regulators, and other authorities that supervise Financial Market Infrastructures ("FMI"). Responsibility E sets the standards for cross-border cooperation between authorities stating that authorities should establish cooperative arrangements to "minimise the potential duplication of effort and the burden on the FMIs or the cooperating authorities."[1] The PFMIs also state that the "objective of such arrangements is to facilitate the comprehensive regulation, supervision, and oversight and to provide a mechanism whereby the responsibilities of multiple authorities can be fulfilled efficiently and effectively."

The regulatory recognition regimes in the US and EU are both progressing towards this desired outcome. Non-US CCPs operating in the US must either register as a DCO with the CFTC or be exempt from registration.[2] There is authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") for the CFTC to exempt a foreign CCP from registration "if it is subject to comparable, comprehensive supervision and regulation by the appropriate government authorities in its home country."[3] Similarly, Section 17A(k) of the Securities Exchange Act, as added by Section 763(b) of Dodd-Frank, provides that the SEC may grant a conditional or unconditional exemption from clearing agency registration for the clearing of security-based swaps if the SEC determines that the clearing agency is subject to "comparable, comprehensive supervision and regulation by the CFTC or the appropriate government authorities in the home country of the clearing agency."

Although the timing of these recognition processes have differed between jurisdictions,[4] the European Commission, ESMA, CFTC and SEC have expressed a commitment to facilitating a mutual recognition regime for CCPs between the US and EU. We have encouraged and expect continued progress towards this commitment and a firm demonstration from US regulators to exercise their recognition authority under the relevant provisions.[5]

III. The US Legal/Regulatory Framework for CCPs

Clearing houses in the US are subject to comprehensive regulation by numerous regulators depending on the type and size of their clearing services. For example, futures and swaps clearing houses in the US must register as DCOs pursuant to the US Commodity Exchange Act ("CEA" or the "Act") and under the regulations of the CFTC. The CFTC is the lead regulator for DCOs, but clearing houses that clear single name and narrow index credit default swaps are subject to limited oversight from the SEC. DCOs that are designated as a systemically important financial market utility ("SIFMU") by the Financial Stability Oversight Council ("FSOC") under Title VIII of Dodd-Frank are subject to additional oversight by the Board of Governors of the Federal Reserve ("Federal Reserve"). Subject to this oversight, SIFMUs will have access to Federal Reserve services, among them the ability to deposit cash in an interest-bearing account with the Reserve Bank.

[1] PFMI, Responsibility E, Explanatory note 4.5.1

[2] Dodd-Frank, Section 723 (a)(3) created CEA Section 2(h)(1), which provides that "it should be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a DCO that is registered under this Act or a DCO that is exempt from registration under this Act." CEA Section 2(h)(4) further provides that the "CFTC should prescribe rules that prevent evasion of clearing requirement."

[3] Dodd-Frank Section 725 (b) created CEA Section 5b(h), allowing the Commission to exempt a DCO from registration "if it is subject to comparable, comprehensive supervision and regulation by the appropriate government authorities in its home country."

[4] A common theme regarding the implementation of enhanced regulations in response to the global financial crisis in 2008.

[5] A similar regime already exists for foreign boards of trade.

The CEA and the CFTC

The CFTC is the lead supervisory agency for all DCOs and is a successor federal regulator to the Grain Futures Administration (from 1922 until 1936) and the Commodity Exchange Authority (from 1936 until 1975). The CFTC was created in 1975 with authority under the CEA. The CEA has been modified numerous times over the years, with recent modifications in 2000 with the Commodities Futures Modernization Act ("CFMA") and in 2010 under Dodd-Frank. The CFMA required registration of DCOs and established core principles with which a DCO must comply. Dodd-Frank revised the CEA and established eighteen DCO Core Principles,[6] which are implemented by 15 regulations (Part 39 of the CFTC Regulations).
A major focus of the CEA is customer protection. The CEA and the regulations thereunder are rich in provisions for the specific protection of investors' interests. Sections 4b and 4o of the CEA contain antifraud provisions designed to protect customers and clients. Customer protection regulations pursuant to these statutory requirements have been implemented by the CFTC in Parts 1 (1.20 *et seq*), 22, 30 and 39. One of the core tenets of the US customer protection regime is that customer funds must always remain segregated from those of their FCM and must not be used to meet the margin requirements in that FCM's house accounts.[7]

In addition, collateral posted by swaps customers may not be used to meet the margin requirements of any other swaps customer. The legal identity of the owner of each swaps customer account must be provided by the customer's FCM to the relevant DCO to ensure the use of customer swaps collateral is restricted as required by Part 22 of the CFTC Regulations. The segregation of customer funds has a dual purpose of the protection of customer funds in the event of a financial failure of a clearing firm and the insulation of those funds from use by others. Additional practices covered in the CEA that may violate the antifraud provisions of the CEA include excessive trading by persons in control of customer accounts, trading without the customer's authorization, failing to properly segregate customer funds, willfully making false statements or keeping false records, noncompetitive execution of orders and other dishonest practices.

CFTC oversight of DCOs includes—but is not limited to—daily interactions, rule submissions, reporting (daily, quarterly and annual) and ongoing supervision over all major functions of a DCO. The CFTC also conducts annual formal examinations of a DCO's compliance with Title VIII of Dodd-Frank and a subset of the DCO Core Principles. A typical CFTC Examination includes an in depth review of up to six Core Principles, and information would be provided for said reviews via requests for documentation, conference calls, or on-site hearings. The Core Principles that are applicable to the CCP and are eligible for review may include, for example, available financial resources, treatment of funds, risk management practices, default rules and procedures, recordkeeping, reporting, or settlement procedures. The objective of each review is to assess CME's compliance with the provisions of Title VIII of Dodd-Frank (and the rules promulgated thereunder) and the CEA. Examination proceedings may also include the SEC and Federal Reserve to the extent they maintain jurisdiction over the selected subject matter.

Core Principle (A) requires all DCOs to establish and staff the position of Chief Compliance Officer ("CCO"), who is obligated to establish and administer policies and procedures reasonably designed to prevent a violation of the CEA. These oversight measures are designed to ensure DCOs comply with Title VIII of Dodd Frank, the DCO Core Principles and the CFTC regulations promulgated thereunder. In addition, Core Principle (D) requires DCOs to have a Chief Risk Officer ("CRO") who is responsible for implementing the risk management framework for the DCO, including its risk management policies,

[6] The DCO Core Principles include: (A) Compliance; (B) Financial Resources; (C) Participant and Product Eligibility; (D) Risk Management; (E) Settlement Procedures; (F) Treatment of Funds; (G) Default Rules and Procedures; (H) Rule Enforcement; (I) System Safeguards; (J) Reporting; (K) Recordkeeping; (L) Public Information; (M) Information Sharing; (N) Antitrust Considerations; (O) Governance Arrangements; (P) Conflicts of Interest; (Q) Composition of Governing Boards; (R) Legal Risk
7 Section 766.H of the US Bankruptcy Code prevents US CCPs from providing individual segregation.

procedures and controls. The CRO must also make appropriate recommendations to the DCO's risk management committee or board of directors, as appropriate, regarding the DCO's risk management functions.

We also draw the EC's attention particularly to the interaction of client protection rules at an FCM level which are covered in more detail below and are not easily evaluated through a simple factor by factor analysis of US CCP regulations. Finally, we expect the CFTC to incorporate the PFMIs into their legal and regulatory framework by the end of 2013.

The Federal Reserve

The United States Department of Treasury, Office of the FSOC, notified CME on July 18, 2012 of its final determination to designate CME as a SIFMU under Title VIII of Dodd-Frank. This subjects CME to additional oversight by the Federal Reserve. Initial oversight by the Federal Reserve is effectuated through participation in CFTC annual examinations and the requirement that CME provide both the CFTC and the Federal Reserve 60 days advance notice of any proposed change to its rules, procedures, or operations that could materially affect the nature or level of risks presented by CME.

The SEC

The SEC published Clearing Agency Standards, 17 CFR Part 240, on November 2, 2012. The standards establish minimum requirements for registered clearing agencies to maintain effective risk management procedures and controls as well as meet the statutory requirements under the Securities and Exchange Act on an ongoing basis. The new standards for clearing agencies are set forth in § 240.17ad–22. DCOs, such as CME, providing, or planning to provide, clearing services for single name and narrow index credit default swaps were deemed registered as clearing agencies by Dodd-Frank. Consequently, certain changes to a DCOs rules, policies and procedures must be submitted to the SEC, as well as the CFTC, for review, and in some cases approval, due to this deemed registration.

CPSS-IOSCO

CPSS-IOSCO published the PFMIs on April 16, 2012. Under the PFMIs, FMIs include systemically important payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories.

The Principles and the Responsibilities set forth in the PFMIs ("Principles" and "Responsibilities", respectively) are expected to be imposed upon FMIs by relevant authorities pursuant to five Responsibilities for central banks, market regulators and other relevant authorities. Responsibility D requires each relevant authority to adopt the PFMIs and apply them consistently. Further, the PFMIs require CCPs involved in activities with more complex risk profiles or that are systemically important in multiple jurisdictions (SIFMIs) to comply with higher standards for financial resources, liquidity requirements,[8] and business continuity.

Consistent with the G20 commitment for centralized clearing and data reporting for OTC derivatives, we understand CPSS-IOSCO member regulators are planning to adopt regulations consistent with the PFMIs by the end of 2013. We believe that the PFMIs serve a valuable purpose by providing flexible standards which allow different jurisdictions to adopt regulations that comply with best practices while also accounting for the vagaries of different market dynamics. CME expects the CFTC to adopt final

[8] To date, the Federal Reserve has taken a very conservative approach to the liquidity requirements for US-based CCPs and it is expected that they will require significant liquidity facilities and/or cash on the balance sheet to comply with this PFMI. While the liquidity requirements for US CCPs have not been finalized, this provides a good example of the evolving standards which will not be accounted for in the planned equivalence determination by the EC.

regulations consistent with all PFMIs not previously addressed in the DCO Core Principles by December 31, 2013, and has already commenced a detailed review of its practices in light of the PFMIs to confirm its compliance with all relevant requirements.

IV. CCP Best Practices for Risk Mitigation

This section provides an overview of best practices for clearing houses and the various issues that should be considered in designing a holistic risk management framework at any CCP (whether based in the US, EU or elsewhere). A CCP's purpose is to provide protection to financial markets through the management, containment, mitigation, and prevention of systemic risk, while maintaining the protection of customer interests. Risk management standards and practices should be neutral, unbiased, and independent from business and commercial units. A strong risk culture is integral in the establishment of effective risk management processes as set out below.
A CCP should employ a wide range of techniques to assess the level of financial risks to which its activity is exposed under both normal and extreme conditions. Some of the risk factors considered include:

- *Operational Risk* – The risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events
- *Credit/Counterparty Risk* – The risk that a counterparty will not settle an obligation for full value either when due, or anytime thereafter
- *Market Risk* – The risk of loss resulting from changes in market values of collateral and from market volatility affecting the ability of counterparties to settle their obligations
- *Liquidity Risk* – The risk of loss resulting from the inability to offset exposures in the market at prevailing prices

A. <u>Monitoring the Adequacy of Financial Safeguards</u>

1. *Risk Management Framework*

The adequacy of the financial safeguards should be monitored daily through the utilization of robust risk management procedures and controls. This includes daily risk management monitoring, stress testing, model validation, model backtesting, and operational risk management controls. To ensure the stability of the various layers of financial safeguards, parameters should be monitored throughout the day, including intra-day price movements of products in relation to current initial margin levels, trading activity and profits/losses of market participants. In monitoring clearing member exposures and the adequacy of the CCP's financial safeguards, a CCP should employ a robust risk management framework that includes:

- Credit Risk Management
- Market Risk Management
- Model Risk Management
- Operational Risk Management
- Liquidity Risk Management
- Concentration Risk Management
- Default Risk Management

The framework should be reviewed annually by the CCP's Risk Committee and Board of Directors.

2. *CCP Contributions*

CCPs should earmark capital as financial resources available for use in a clearing member default. This is an important element of a CCP's waterfall as it demonstrates the CCP's vested interest and commitment to ensuring adequate financial requirements are maintained and robust risk management practices are employed by clearing members. Clearing members also view this as a strong sign of commitment to the business by the CCP and typically look for CCPs to contribute prior to a growth in activity for a particular asset class or default fund.[9]

3. Establishing Initial Margin

Initial margin is a critical layer of financial safeguards established on the principle that sufficient collateral should be held at all times to cover potential market risk the CCP may be exposed to from clearing member positions. The PFMIs state generally that "a CCP should cover its credit exposures to its participants for all products through an effective margin system that is risk based and regularly reviewed."[10] The explanatory notes elaborate on the basic principle that the margin levels should match the risk profile of the product.[11] There are two components involved when determining initial margin: (a) the margin model and (b) the input parameters to be consumed by the model.

(a) *Initial Margin Models*

Initial margin models should utilize a risk-based methodology that fairly reflects the inherent risks within each clearing member's portfolio. Input parameters reflect a minimum confidence interval as measured by the percentage of time during which margin is greater than mark-to-market movements on a historical basis, as well as the margin period of risk, which should ensure the margin will cover price movements over the length of time the CCP expects necessary for liquidating a portfolio.

Additionally, a CCP may employ additional forms of margin to enhance initial margin coverage such as concentration margin and liquidity margin, as well as retain the right to charge a clearing member or customer additional margin in assessing the risk profile of the portfolio.

(b) *Treatment of Collateral*

To safeguard against the potential default of a clearing member, a CCP should employ a policy for establishing and reviewing its criteria for acceptable collateral for initial margin. Haircuts and limits should be established with consideration given to the unique characteristics of different asset types when determining the necessary confidence interval and holding period, taking into account the liquidity of the market. The CCP should have liquidation arrangements in place to support the rapid utilization of collateral if it becomes necessary.

(c) Initial Margin Parameters

CCPs should employ neutral standards in all areas of risk management, including when they determine the appropriate margin periods of risk for different product types. The most important question a CCP should consider is how much initial margin is required to efficiently liquidate the position or portfolio[12] (since variation margin marks to market each day and eliminates debt from the market), so as to minimize the likelihood that default liquidation costs exceed margin cover. CCPs can, and do, use different portfolio risk assessment models to assess clearing member

[9] CME's contributed capital across it three guaranty funds is approximately $350 million, which is currently the largest contributed capital commitment of any global CCP.
[10] PFMI Principle 6
[11] Principle 6, explanatory note 3.6.3, "when setting margin requirements, a CCP should have a margin system that establishes margin levels commensurate with the risks and particular attributes of each product, portfolio, and market it serves."
[12] CME was able to liquidate Lehman's futures house book in 6 hours and within margin cover despite the complexity and size of a portfolio that spanned all major product categories.

margin requirements in different markets. That said, a CCP should evaluate a variety of factors in assessing appropriate margin cover levels, including:

- historical volatility
- intra-day volatility
- implied volatility
- seasonal volatility
- price limits
- impending government statistical data releases
- liquidity
- market concentration
- current and anticipated market conditions
- the market's ability to price and value a position or portfolio
- the frequency of margin collection/settlement

V. US FCM Regulatory Protections

While CCPs employ multiple layers or protections against clearing member losses, it is important to note that clearing members themselves are required to establish FCM-level layers of protection primarily focused on the protection of customer funds. In the US, the CFTC, National Futures Association ("NFA") and the relevant futures exchanges, have created a unique system of oversight which results in enhanced protection for customers by ensuring multiple layers of review of industry risk management, financial and operational practices. An overview of this oversight structure and recent enhancements to customer protections is provided below.

A. FCM Audit and Examination Program

US exchanges and the NFA have been delegated primary responsibility by the CFTC for ensuring market participants are adhering to applicable rules and regulations.[13] The Joint Audit Committee ("JAC") was formed to enhance uniformity among participants as well as lessen the regulatory burden for firms which are members of multiple exchanges.

The JAC is a representative committee of the financial surveillance departments of US futures exchanges and regulatory organizations. Through the JAC, FCMs are assigned a lead futures regulator referred to as the designated self-regulatory organization ("DSRO").[14] The DSRO is responsible for performing risk-based examinations designed to meet the goals of customer protection and exchange financial integrity. Such examinations are conducted in accordance with the Joint Audit Program ("JAC Program"), which is reviewed by the CFTC. Finalized risk-based examinations are given to the CFTC on a monthly basis. The CFTC may review a sample of the examinations performed by DSROs to ensure DSROs are performing examinations in accordance with the JAC Program. The CFTC may, at its discretion, perform its own examination of an FCM.

The CFTC requires that a risk-based examination be performed of an FCM within 9 to 18 months of the "as of" date of the previous examination. In general, FCMs are reviewed at least every 15 months, with only extenuating circumstances and extremely low risk firms reviewed on an 18-month cycle. Such flexibility allows DSRO resources to be focused on those firms posing the greatest risks to the industry. In performing a risk-based examination, an assessment is made of the FCM so that areas of risk are targeted for review. While the work performed helps ensure that the firm is in compliance with capital, segregation/secured/cleared swaps customer, recordkeeping, and reporting requirements, some sections

[13] CFTC, NFA and exchange rules and regulations.
[14] CME is the DSRO for all of its FCM clearing members.

of the JAC Program may not be performed on every examination. However, all core program sections must be performed, as applicable, at least once every 3 examination cycles.

In general, the programs include, in part, steps for: establishing the scope of the exam, completing the preliminary risk analysis review, performing a tie-out from the general ledger to the financial statements, documenting the firm profile (which identifies the firm's exchange memberships, carrying broker, introducing broker and omnibus account relationships, and type and number of accounts it carries), reviewing customer complaints and documenting the administrative steps of the examination. In addition, a general questionnaire is completed which documents the firm's financial, operational and risk management procedures and practices.

Compliance testing is performed to ensure FCMs, their branch offices and their guaranteed introducing brokers ("GIBs") are in compliance with applicable requirements. A review of internal audit reports, other regulatory examination reports, commissions generated (to identify high volume brokers), and customer complaints is performed for the FCM's branch offices and GIBs at the start of each examination. The results of this analysis are a key component in determining the scope of the compliance programs executed in the examination.

The JAC Program contains the following compliance areas which must be completed at least once every three examination cycles:

- Books and Records
- Customer Accounts
- Discretionary
- Margins
- Anti-Money Laundering
- Disaster Recovery
- Sales Practice
- Privacy Rules

The Financial examination programs review the firm's procedures for reconciling its account balances, presenting financial information, computing net capital, and reporting segregation, secured and cleared swaps customer amounts. The JAC Program contains the following financial areas which must be completed at least once every 3 examination cycles:

- Cash at Banks
- Securities, at Market Value
- Receivables from/Payables to and Deposits with US/Foreign Commodity Clearing Organizations
- Receivables from/Payables to Registered FCMs and Foreign Commodity Brokers
- Receivables from Traders on US and Foreign Boards of Trade
- Equities in Customers', Noncustomers', and General Partners' Commodity Accounts
- Liabilities Subordinated to Claims of General Creditors
- Subsequent Review
- Statement of the Computation of the Minimum Capital Requirements

All risk-based examinations are reviewed by the DSRO's Financial Surveillance team's management and the results discussed with the firm's management. A report is issued to the firm's senior management noting significant problems and material adjustments and requesting, if necessary, a written response addressing the items noted. The results of examinations are shared with other self-regulatory organizations of which the firm is a member, as well as the NFA and CFTC.

Disciplinary committees of the various exchanges, or the NFA or CFTC, may review the risk-based examination reports and may take disciplinary action against the firm if deemed appropriate. Such disciplinary action may include letters of warning or charging the firm with Exchange/NFA rule violations.

If a firm is charged with a rule violation, it is posted/published to the Exchange community and is available on the NFA's public BASIC system. In addition to the risk-based examinations detailed above, DSROs continually monitor the financial position of FCMs through (1) monthly financial statement submissions, (2) daily and semi-monthly customer protection statements as outlined below, and (3) continuous communication with FCMs regarding changes to their business activities, new regulations and their impact to the firm, and industry events.

Through the JAC and the issuance of JAC Regulatory Update Bulletins, the FCM community is kept up-to-date on proposed and new regulations, the interpretation and application of rules, and common industry issues. Such bulletins provide FCMs with more detailed and specific information to ensure they remain in compliance with all industry rules and regulations.

B. Enhancements to Customer Protection

Recently, industry groups and regulators have diligently worked together to enhance the customer protection regime. These enhancements are set out in Sections 4 and 16 of the National Futures Association Rulebook and include:

1. Maintenance of Excess Customer Funds

FCMs must maintain excess customer funds at all times, including on an intra-day basis. FCMs are required to set a target level of excess funds to be maintained with such target approved by the Board of Directors or other governing board. In determining the targeted level of excess funds, the FCM should consider the nature of the firm's business, including but not limited to: the firm's type of customers, their general creditworthiness, and trading activity; the type of markets and products traded by the firm's customers and the firm itself; the general volatility and liquidity of those markets and products; the firm's own liquidity and capital needs; and historical trends in customer segregated/secured amount funds balances and customer debits.

2. Daily Customer Statements and Account Balance Confirmation

All FCMs are required to file daily customer statements by 12 PM on the following business day, with such statements signed off by the firm's CEO, CFO or their designated representative. The daily statements are monitored for timely submission and excess funds held. Material decreases in excess funds are investigated by staff and, if required, proper notification is made. Daily statements are compared to month-end financial statements for reasonableness with differences investigated and documented. Most significantly, all FCMs must authorize their bank depositories to provide daily end-of-day account balances for all customer accounts. Only those cash and security balances held at banks that are reported by the banks are considered good customer assets in the respective customer calculations. On a daily basis the reported balances from the banks are compared to the firm-reported balances with material variances investigated. As a further enhancement, balances at clearing organizations and brokers will be required to be reported over the next several months.

3. Reports of Investments

All FCMs file semi-monthly reports of investments reflecting how customer funds are invested and where those funds are held. These reports are reviewed for compliance with CFTC Regulation 1.25, which details allowable investments of customer funds.

4. Disbursements Approval

All disbursements made by FCMs of customer funds that are not made for the benefit of a customer and that exceed 25% of excess customer funds must be pre-approved in writing by the firm's CEO, CFO or authorized representative. Further, FCMs must immediately notify their designated self-regulatory organization (lead regulator) upon pre-approval confirming the transaction details as well as confirmation that the firm continues to maintain excess funds above their targeted amount. Compliance with the disbursements rule is monitored during daily statement reviews (analyzing decreases in excess of 25% or more from one day to the next) and during risk-based examinations.

5. *Examinations*

All FCMs are subject to risk-based examinations by their designated self-regulatory organization every 9 to 18 months. The timing and the scope of the examination is based on a risk profile of the FCM based on the firm's history, business activities; recent events such as mergers or changes in lines of business; daily, semi-monthly, monthly and annual financial statements; results of previous risk-based examinations and ongoing correspondence and communication with the firm. Risk-based examinations include financial requirements such as net capital and customer balance computations as well as compliance areas such as performance bonds, discretionary trading and customer account documentation. As new rules are adopted, they are promptly included in the review programs utilized during risk-based examinations. Further limited reviews of customer statements are conducted on a surprise basis outside of the regular risk-based examinations as of an intra-month statement date.

6. *Transparency*

Transparency is key to the industry and while selected financial information of FCMs has been posted on the CFTC's website, further financial information concerning FCMs is posted on NFA's website. The information currently posted by the NFA includes capital balances, customer funds balances and information of the firms' investments of customer funds. The customer protections required of FCMs and continuously monitored by the self-regulatory organizations provide a strong customer protection regime in the US, and the industry continues to work to evaluate and consider further enhancements to customer protections.

V. Variance Between Key CCP Regulatory Requirements in the US and EU

As noted above, CME believes that any analysis of equivalence should be outcome-determinative, based on the PFMIs and viewed holistically rather than on a factor-by-factor basis. There are several areas of variance between the US and EU frameworks for CCPs, including differences between the ESMA RTS and CFTC final rule on DCO Core Principles. In some areas such as margin period of risk ("MPOR"), the EU requirements as set out in EMIR are more onerous while in others such as real-time clearing, FCM-level protections (as covered above) and permissible investments the US have higher standards. More often than not, the standards are simply different but provide market participants with similar levels of protection and risk mitigation. Below we evaluate these areas within the context of the cverall regulatory package of CCP risk mitigation regulations and self-employed risk management policies and systems.

A. <u>Financial Safeguards to Protect Against Default</u>

One of the key pillars of CCP protections is the establishment of adequate financial safeguards, designed to include multiple layers of protection against clearing member losses in the event of a clearing member default. The layers of protection typically include 1) rigorous membership requirements, 2) daily mark-to-market, 3) initial margin, 4) default fund, 5) capital contributed by the CCP, and 6) additional provisions for satisfying any potential default obligation.

1. Minimum Membership Requirements

The PFMIs focus on three key areas for membership requirement standards, stating that these standards should be 1) objective, 2) risk based, and 3) publicly disclosed.[15] Membership requirements should permit objective and open access for clearing members, while maintaining prudent risk management standards at the CCP. Requirements generally include maintaining adequate financial resources, satisfying risk-based capital requirements, contributing to the default fund, and demonstrating appropriate risk management policies and procedures.

EMIR sets the participation requirements for CCPs and leaves the responsibility to the CCP to define membership criteria within certain parameters and upon advice of the CCP's risk committee.[16] EMIR states that these requirements must be "non-discriminatory, transparent and objective." Any requirements that have the effect of restricting access will only be allowed to the extent that the objective is to control risk for the CCP.

The US rules take a slightly more prescriptive approach to membership requirements in CFTC Regulation 39.12, which includes a cap on minimum financial requirements for swap clearing members. CFTC regulations also require minimum operational requirements that focus on the ability to clear expected volumes and specific financial reporting obligations while requiring that DCOs allow all market participants who meet clearing membership standards to become clearing members. Further, DCOs may not exclude certain types of market participants from clearing membership unless the exclusion is based on credit risk or operational deficiencies. While the specific requirements differ between the EU and US, the overarching theme of CFTC regulations, like EU the regulations, is fairness, transparency and objectivity in applying standards for clearing membership.

Analysis – Although the EU and the US take slightly different approaches to the implementation of minimum membership requirements, both regulatory regimes are designed to meet the PFMI objective that membership standards be objective, risk based and publicly disclosed. In addition, both standards require access restrictions to focus on CCP risk mitigation (financial and operational) to prevent CCPs from unfairly advantaging or disadvantaging market participants with similar capital, financial sophistication and operational expertise. These standards are broadly similar and achieve the same policy goals so they should not impact a finding of equivalence by the EC.

2. Daily mark-to-market and margining

Principle 4 of the PFMI's requires daily mark-to-market.[17] Daily mark-to-market promotes financial stability throughout the financial system by monitoring and removing accumulated debt obligations among market participants. While daily marking of trade exposures is a minimum requirement, some CCPs in the US commonly mark trade exposures to market on a more frequent basis, typically twice daily, for some markets. Daily recalculation of initial margin requirements ensures the CCP holds sufficient collateral to protect against potential losses that may accumulate between daily mark-to-market cycles.

EMIR requires CCPs to measure and assess their liquidity and credit exposures to each clearing member on a near- to real-time basis (art. 40 EMIR), to fully collateralize its exposures at least on a daily basis (art. 41 EMIR) and to call and collect margins on an intra-day basis, at least when predefined thresholds

[15] PFMI Principle 18.
[16] EMIR, Article 37, Participation requirements
[17] Principle 4 'Credit Risk' states, "A CCP should mitigate its credit risk to the extent possible. For example, to control the build-up of current exposures, ***a CCP should require that open positions be marked to market and that each participant pay funds, typically in the form of variation margin, to cover any loss in its positions' net value at least daily***; such a requirement limits the accumulation of current exposures and therefore mitigates potential future exposures. In addition, a CCP should have the authority and operational capacity to make intraday margin calls, both scheduled and unscheduled, from participants."

are exceeded (art. 41.3).[18] CFTC Regulations 39.13(e)(1) and (2) require DCOs to measure their credit exposure and mark to market their clearing members house/customer positions at least once each business day and to monitor their credit exposure to clearing members periodically during the day. Additionally, CFTC Regulation 39.14(b) requires DCOs to conduct daily settlements where they pay and collect variation margin based on the price movements of futures, swaps and options margined at the clearing house.

Analysis – The US and EU regulatory frameworks each meet the requirements of the PFMIs and take similar approaches to risk management. In both cases, trade exposures must be frequently monitored and margin must be paid and collected on at least a daily basis. EMIR uses "near to real time" language when discussing the requirement to assess trade exposures while the CFTC requires exposures to be monitored "periodically." Pursuant to the results of this monitoring, daily payment and collection of margin must be completed intra-day under EMIR and at least daily under CFTC regulations. Although the specific language used in the EU and US regulations differs, the practical result is identical in both cases, the mitigation of systemic risks to the marketplace through the daily elimination of market price driven debt. This substantially similar end result of two "different" regulatory frameworks argues strongly in favor of an outcome-determinative[19] approach to the finding of equivalence.

3. *Minimum MPOR and Confidence Intervals*

(a) *Margin period of risk*

EMIR rules require a minimum MPOR of 5 days for OTC derivatives and 2 days for financial instruments other than OTC derivatives.[20] The CFTC rules require a minimum MPOR of 1 day for exchange-traded derivatives and commodity swaps and 5 days for financial swaps or OTC derivatives.[21]

(b) *Confidence intervals*

EMIR rules require a 99.5% minimum for OTC and 99% for other instruments.[22] US rules require a minimum of 99% for all derivatives,[23] making the EU slightly more restrictive than the US for OTC derivatives.

Analysis – CME appreciates the importance of confidence intervals and MPOR to the overall risk management framework of a clearing house. However, there are many factors that should be considered when setting margin and neither the EU nor the US regulations account for all of these factors; nor should they due to the dynamic nature of the markets and the qualitative considerations that are important when designing a risk management framework. In particular, the practice of marking exchange-traded derivatives to market on a twice-daily basis is a very effective tool for maintaining the integrity of the CCP's credit exposure to its clearing membership. CCPs may also employ alternate means of maintaining the integrity of the CCP's credit exposure to its clearing membership—calling for additional margin, for instance, as opposed to utilizing an intra-day variation margin cycle. Additionally, throughout this letter, we have addressed the need for a holistic risk management approach at CCPs. This approach must account for the regulatory requirements set out by a CCP's home regulator, but should also consider factors not specifically addressed by regulation. CCPs must also account for the products and markets where it provides clearing services. Some of the factors considered by CME that are not necessarily addressed in EMIR or the CFTC regulations are covered below. In many cases, these factors

[18] EMIR Articles 40 and 41
[19] Rather than a factor-by-factor or line-by-line analysis
[20] EMIR RTS, Article 26
[21] CFTC Regulation 39.13(g)(2)(ii)(A)-(C)
[22] EMIR RTS Article 24
[23] CFTC Regulation 39.13(g)(2)(iii)

require the expert judgment of the CCP's risk management staff based on their understanding of and closeness to their markets and major market participants. CCPs that do not have staff with this required level of expertise and knowledge may not perform the proper level of risk management no matter the regulatory framework in which they are required to operate. In many cases these enhanced risk management protections are covered by the broad language of PFMI 6 and may result in a US-based CCP having higher initial margin requirements than one based in the EU, despite the fact that only 1-day MPOR is required under US regulation for exchanged-traded derivatives and commodity swaps.

(c) *Impact of Agency Reports on Margins*

One factor that is not considered by either US or EU CCP regulations is the impact of agency reports on the margin required for commodity products. On March 26, 2013, CME increased corn margins above the $1250.00 margin requirement suggested by 99% confidence intervals and 1-day MPOR in advance of a crop report by the United States Department of Agriculture (USDA). In this case, initial margin was set at $2,000 or 60% above the regulatory requirement. This decision was prescient because the next few days after the report saw very large moves in the corn market. CME has decided to maintain these heightened margin requirements until we receive more information about the 2013 crop and weather volatility lessens. Depending on circumstances, CME could have decided to increase initial margins even more to account for prospective volatility following a USDA report. Finally, this successful example demonstrates one potential impact of expert judgment and the need to factor supplementary market-related information into margin levels, but there are many similar examples where qualitative factors may guide CCP margin levels for different products.

(d) *Volatility Floors*

MPOR and confidence intervals also do not account for the impact of a low volatility market on margins and the potential of CCPs to introduce margin floors in some circumstances. Frequently, a volatility floor may be utilized to ensure periods of lower volatility do not underestimate the potential for higher volatility to return. For example, US interest rates have experienced extremely low volatility over the past few years; however, the potential for increased volatility often results in a floor being used for margin levels. Where a minimum of 1-day MPOR may be the standard for most exchange-traded interest rate products due to the high liquidity profile of the market, in periods of lower volatility, the floored margin requirement may indicate a longer MPOR.

Although the current minimum regulatory environment requires a 1-day MPOR, approximately half of CME's open interest is margined using a 1.5- or 2-day period of risk. Examples of products that have initial margin levels above the 1-day MPOR, 99% confidence interval requirement are provided below. As you will note, some of the margin levels are significantly higher than requirements and have been imposed on some of CME's largest and most liquid products.

<u>S&P 500 Futures</u>

- 1-day, 12 month 99% confidence interval is $9,025
- 2-day, 12 month 99% confident interval is $12,635
- Current margin is $17,500 (approximately 95% higher than 1-day)

<u>Eurodollar Futures</u>

- 1-day, 12 month 99% confidence interval is $31
- 2-day, 12 month 99% confidence interval is $43.40
- Current margin is $200 (approximately 545% higher than 1-day)

30 Day Federal Funds Futures

- 1-day, 12 month 99% confidence interval is $23
- 2-day, 12 month 99% confidence interval is $32.20
- Current margin is $250 (approximately 980% higher than 1-day)

(e) *Concentration Margin Add-ons*

CME also considers position concentration in the construction of its margin program. At the clearing member level, CME maintains a concentration margin program where clearing members are subject to an additional concentration margin charge if they hold positions that are sufficiently large to trigger the concentration charge within an asset class. Each major asset class maintains a unique trigger for its concentration charge, as well as a unique charge imposed as a result of the exposure. This allows the clearing house to charge additional margin to account for clearing members' potential market exposures due to large positions relative to the financial resources available to support those positions, while taking into account the differences between the markets and typical position sizes in each major asset class.

4. Financial Resources Requirements/Default Fund

The next layer of protection, the default fund, should be established to cover potential exposures of the largest clearing members.[24] Clearing member contributions to the default fund should reflect the level of risk each clearing member brings to the CCP and scale appropriately with increasing activity levels. The PFMIs provide a general description of the trade-offs that CCPs weigh in analyzing the size of prefunded default arrangement as a tool to protect against credit risk.[25]

Under EMIR, the default fund is required to allow the CCP to withstand, *under extreme but plausible market conditions*, the default of the clearing member to which it has the largest exposures or of the second- and third-largest clearing members, if the sum of their exposures is larger.[26] In addition, the total prefunded financial resources must at all times enable the CCP to withstand the default of the two clearing members to which it has the largest exposures.[27] CCPs in Europe must also maintain at least €7.5 million in initial capital and sufficient capital to allow an orderly winding down or restructuring of activities over an appropriate time span of not less than six months.[28]

CFTC Regulations 39.11(a)(1) and 39.11(a)(2) require a US CCP "to meet its financial obligations to its clearing members notwithstanding a default by the clearing member creating the largest financial exposure for the derivatives clearing organization in extreme but plausible market conditions...." and "[e]nable the derivatives clearing organization to cover its operating costs for a period of at least one year, calculated on a rolling basis." Additionally, CCPs deemed SIFMUs will be required to meet financial obligations to their clearing members notwithstanding a default by the two clearing members creating the two largest financial exposures for the CCP in extreme but plausible market conditions ("Cover 2"). While this heightened standard for SIFMUs has not yet gone into effect in the US, it is expected to be final by the end of 2013.

[24] CPSS IOSCO Principle 4 states that "a CCP that is involved in activities with a more-complex risk profile or that is systemically important in multiple jurisdictions should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the two participants and their affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions. All other CCPs should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions."
[25] PFMI, Principle 4, Credit Risk, Explanatory Note 3.4.17, including footnote 54, p. 42
[26] EMIR Article 42.3
[27] EMIR Article 43.2
[28] EMIR Article 16.1

Analysis – The default fund/financial resources requirements under EMIR and the CFTC regulations are broadly similar. In both cases, CCPs must have the ability to withstand the default of the clearing member to which it has the largest exposure (or second- and third-largest combined, in the case of EMIR). Under EMIR, this requirement is default fund-specific and there is a separate requirement when counting all financial resources to withstand the default of the largest two clearing members (and hold at least € 7.5 million in capital and allow for an orderly wind down) whereas the US requires all financial resources to also cover 12 months operating expenses. As mentioned above, SIFMUs will have heightened financial resources requirements in the US that require them to meet a Cover 2 standard and cover 12 months in operating costs. Essentially, the EMIR standards could be viewed as more onerous in the case of non-SIFMUs (assuming covering the second largest clearing member default plus €7.5 million and any wind down expenses in capital is greater than 12 months operating costs) and potentially less restrictive in the case of SIFMUs like CME. Since the standards are substantially similar and each could be viewed as more restrictive in certain circumstances, we do not believe the differences between the two financial resources regimes should impact the EC's equivalency determination.

5. *Procyclicality*

EMIR requires that CCPs use one of three options to protect against procyclicality.[29] In particular, CCPs can: (a) implement a buffer of at least 25% to its minimum margin requirements, which can be used in stressed market conditions to avoid continuous margin calls; (b) assign a weight of at least 25% to the stress observations considered in the calculated lookback period; or (c) ensure that the margins are no lower than those calculated considering a 10-year lookback period.

CFTC Regulation 39.13(g)(12) requires DCOs to "apply appropriate reductions in value to reflect credit, market, and liquidity risks (haircuts), to the assets that it accepts in satisfaction of initial margin obligations, taking into consideration stressed market conditions...." In addition, CFTC Regulation 19.13(g)(8)(ii) states that DCOs must require their clearing members to collect initial margin from their customers, for non-hedge positions, at a level greater than 100% of the DCO's initial margin requirements. A DCO has discretion to set percentage by which customer initial margins must exceed the product requirements but the CFTC has the authority to review the percentage levels and require different levels if it deems them insufficient.

Analysis – The CFTC and ESMA apply different methods to deal with procyclicality but both have regulations that deal with its potential effects. In each case, the goal of having regulations addressing procyclicality is to create margin buffers in low volatility environments in anticipation of increased volatility in times of market stress. As highlighted in the discussion below, the implementation of CFTC regulations on the procyclicality result in similar margin buffers as those that would exist under ESMA regulations. In addition to CFTC regulations, CME deploys volatility floors which ensure that margin remains elevated ruing periods of relative calm in anticipation of increased volatility periods in times around systemic events.

These floors are calibrated based on longest lookback periods possible, sometimes even greater than 10 years, commensurate with option (c) in Article 28. In addition, coming off of a large market dislocation, our risk methodologies have parameters that would be adjusted to slow the decay in volatility and hence slower release of margins, providing similar counter-cyclical behavior. In margining products where there is no explicit persistence of shocks from stress periods, we are also analyzing enhancements to the margin methodology to persist periods of stress (e.g. 2008 crisis, 2011 US credit downgrade) in the historical scenario set even when they are outside the rolling look-back window. This would provide effects as prescribed in option (b) mentioned in Article 28.

[29] EMIR RTS 153/3013, Article 28

Additionally, CFTC regulations require DCO clearing members to collect customer initial margin for non-hedge positions, at a level greater than 100% of the DCO's initial margin requirements with respect to each product and swap portfolio. DCOs must collect margin on a gross basis for customer swaps and futures accounts. Typically, these requirements result in a margin buffer of 10% to 35% above the standard initial margin calculation depending on asset class and liquidity profiles. These buffers are allowed to be used during stressed market conditions to avoid margin calls (similar to Article 28(a)).The CFTC also requires DCOs to adopt relatively conservative haircut policies which must take into account stressed market conditions. In part, these haircuts are designed to anticipate the need for increased margin levels and reduced liquidation values in stressed markets.

While we believe that the CFTC regulations dealing with procyclicality result in an equivalent outcome to those proposed by ESMA, we also believe that the volatility floors implemented by CME demonstrate the importance of flexibility and expert judgment in a CCP's risk management framework. The fact that volatility floors are not specifically contemplated by either regulatory regime again demonstrates that a factor-by-factor test for equivalency does not make sense from a policy perspective. Additional risk factors designed to protect the marketplace will always be utilized by sophisticated CCPs in advance of any regulatory mandate.

6. *Real-Time Clearing*

Although ESMA has recognized the benefits of real-time clearing in its draft RTS, the EMIR rules do not mandate real-time clearing.[30] In contrast, the CFTC has mandated real-time clearing through CFTC Regulations 1.74(b) and 39.12(b)(7) which state that FCMs and DCOs must "allow for the acceptance or rejection of trades as quickly as would be technologically practicable if fully automated systems were used." In interpretive guidance provided to the marketplace, the CFTC has stated that FCMs must accept or reject trades submitted to them for clearing within 120 seconds and DCOs must accept or reject trades submitted for clearing within 60 seconds.

Analysis – When a cleared OTC derivatives trade is executed, under current processes in the EU and despite the legal obligation to clear, it can remain as an uncleared bilateral exposure for hours or potentially even days before it is accepted for clearing by a CCP, due to, inter alia, manual credit checks and batch processing of CCP clearing registration operated by some CCPs. During this time, counterparties have unsecured credit exposure to each other, not the CCP, and therefore, the G20 objective of using central clearing to reduce counterparty risk is not met and counterparties may not even be afforded EMIR's protections for pure bilateral trades.

This remaining window of counterparty risk compels the buy-side (large corporates, investment funds, etc.) to enter into transactions only with the largest entities that are least likely to fail in the interim period, and requires the maintenance of burdensome bilateral credit support documentation and infrastructure that real-time clearing obviates. These factors restrict the choice of execution counterparties, and inhibit price competition and efficient price discovery.

In contrast, the CFTC regulations provide certainty and clarity in regard to the clearing of OTC transactions. With a DCO, the longest time period during which the customer that submits a trade for clearing would not have clearing certainty (acceptance or rejection) is 180 seconds from the time of submission (rather than hours and potentially days in the case of the EU). This greatly reduces the chances that a large market move or credit issue with their counterparty would negatively impact a customer prior to receiving the protections of central clearing. By way of example, during May 2013 the average time from the posting of an OTC trade with a CME clearing member to accept or reject for clearing was 10.86 seconds. In addition, 98.2% of May 2013 trades were accepted or rejected in less than 1 minute and 99.0% of trades were accepted or rejected in less than 2 minutes. The safety and

[30] ESMA Final Report on Draft Technical Standards under EMIR, 27 September 2012, pp. 20–21

transparency provided to market participants by this "real-time" clearing was one of the central aims of the regulations introduced under Dodd-Frank. The fact that the CFTC has stricter requirements on clearing response times does not necessarily mean that the overall US CCP regulations are more or less conservative than those in the EU. Rather, it provides an illustration of how different jurisdictions can introduce different regulatory standards which, when viewed holistically, can result in similar overall levels of protection.[31]

VI. Conclusion

Once again, we appreciate the significant amount of time and effort that you, EC and ESMA staff, and other regulators have devoted to this matter. As mentioned in some detail above, numerous factors argue in favor of finding the US CCP regulatory framework equivalent including the mutuality and equivalence tenets of the PFMIs which state that equivalence findings should be outcome- determinative. In addition, a finding of non-equivalence limits customers' optionality in choosing a CCP, which could potentially fragment liquidity in certain markets and frustrate the G20's goal of mitigating counterparty risk by moving standardized instruments to central clearing.[32] A finding of non-equivalence would also disregard the fact that the respective regulatory frameworks in the US and the EU have been developed to support markets with different legal frameworks, liquidity pools and transparency standards.

Most importantly, such a finding would overlook the fact that not all best practices for CCP risk mitigation have been codified by regulators and that the US standards are stricter in certain areas such as real-time clearing, FCM customer protection requirements and SIFMU financial resources/default fund requirements which materially impact the overall risk posed by a CCP to its customers and the financial markets in general. We believe the aforementioned policy reasons, legal and risk management frameworks,[33] and guidance provided by CPSS-IOSCO support a positive equivalence determination between the United States' CCP legal and regulatory protections for CCPs and the EMIR framework.

Please contact us for any additional information that would be immediately helpful. We look forward to discussing further and are happy to structure follow-up dialogue at your convenience.

Sincerely,

Tim Doar
Managing Director & Chief Risk Officers
CME Clearing

cc: Jacob Lew, Secretary, US Department of the Treasury
Gary Gensler, Chairman, US Commodity Futures Trading Commission
Mary Jo White, Chairman, US Securities and Exchange Commission
Rodrigo Buenaventura, Head of Markets, European Securities and Markets Authority

---

[31] For example, a US customer has immediate clearing certainty but an EU customer has the option of taking advantage of individual segregation. Depending on the customer and market structure, one regulation could be more or less important in mitigating a specific type of risk. However, in either case the overall regulatory frameworks could still remain broadly equivalent.

[32] Many clearing members have bandwidth constraints in their onboarding of new clients for clearing, which could result in less access to central clearing if a limited number of CCPs are available in each jurisdiction.

[33] US SIFMUs will also have access to central bank liquidity (in contrast to our understanding of European CCPs although we are unclear whether the small number of EU clearing houses jointly authorised as banks and clearing houses actually have access to central bank liquidity), which provides significant risk mitigation where a systemic event causes the financial markets to become illiquid.

Customer Protection Initiatives

For years, the futures industry had an impeccable reputation for safeguarding customer funds deposited at FCMs. Within a very short time frame, we had a shortfall in customer segregated funds at two FCMs and ensuing bankruptcies. Customers at both firms suffered real harm, the type of harm that all regulators attempt to prevent. These customer losses are a reminder that regulators must continuously improve surveillance, examination and fraud detection techniques to keep pace with changing technology and an ever-more-complicated global financial marketplace. Since the PFG and MF Global cases, we have worked closely with the CFTC and other self-regulatory organizations (SROs) to adopt a number of initiatives to further safeguard customer funds.

Daily Confirmations from all Segregated Funds Depositories—NFA and the CME Group have made dramatic changes in the way we monitor FCMs for compliance with segregation requirements. We now require all banks holding customer segregated funds on behalf of an FCM to directly report balances daily to SROs. The SROs perform an automated comparison to the daily reports filed by the FCMs to identify any suspicious discrepancies. Between the CME and NFA, we now confirm balances in over 2,000 bank accounts on a daily basis. In March 2013, NFA and CME Group commenced the next phase of the monitoring system which will focus on confirming balances for customer segregated funds held in non-bank depositories, mainly accounts held at clearing FCMs and clearinghouses. Phase 2 regarding clearing FCMs is scheduled for completion in September and Phase 3 regarding clearinghouses will be completed later this year.

MF Global Rule—All FCMs are now required to provide regulators with immediate notification if they draw down their excess segregated funds (funds deposited by the firm into customer segregated accounts to guard against customer defaults) by 25% in any given day. Such withdrawals must be approved by the CEO, CFO or a financial principal of the firm and the principal must certify that the firm remains in compliance with segregation requirements. This rule became effective on September 1, 2012.

FCM Transparency—All FCMs must file certain basic financial information about the firm with NFA and that information will be posted on NFA's web site. The information includes data on the FCM's capital requirement, excess capital, segregated funds requirement, excess segregated funds and how the firm invests customer segregated funds. The public display of FCM financial information on NFA's website provides investors with another tool to help them conduct due diligence before choosing an FCM. The investing public is now able to visit NFA's website to obtain general information about an FCM, publicly available disciplinary information and financial information. The display of FCM financial information on NFA's website began in November 2012, and these web pages have received over 15,000 hits.

Review of NFA Examination Procedures—NFA's Special Committee for the Protection of Customer Funds—consisting of all public directors—commissioned an independent review of NFA's examination procedures in light of the PFG fraud. The study was conducted by Berkeley Research Group ("BRG"), and former SEC personnel who conducted that regulator's review of the SEC's practices after the Madoff scandal. BRG's report was completed in January 2013. The report stated that "NFA's audits were conducted in a competent manner and the auditors dutifully implemented the appropriate modules that were required". The report, however, also included a number of recommendations designed to improve the operations of NFA's regulatory examinations in the areas of hiring, training, supervision, examination process, risk management, and continuing education. NFA has already taken a number of steps to implement BRG's recommendations. A Special Committee appointed by NFA's Board will oversee the timely implementation of these recommendations.

Internal Controls Guidance—NFA, CME Group and other SROs developed more specific and stringent standards for the internal controls that FCMs must follow to monitor their own compliance with regulatory requirements. NFA has drafted an interpretive notice that contains specific guidance and identifies the minimum required standards for internal controls in a number of areas such as separation of duties; the firm's procedures for complying with customer segregated and secured amount funds requirements; establishing and complying with appropriate risk management and trading practices; restrictions on access to communication and information systems; and monitoring for capital compliance. NFA submitted the interpretive notice to the CFTC for its review and approval.

Insurance Study—In light of the failures of MF Global and PFG, there have been growing calls for some form of customer account insurance. This issue has not been analyzed in detail since NFA performed an insurance study in 1985. Therefore, FIA, the Institute for Financial Markets, the CME Group and NFA have undertaken an industry-funded customer account insurance study. The study will not include recommendations for or against any form of insurance but will analyze and estimate the potential costs and assess the potential benefits of several possible forms of a customer account insurance program.

Detecting and combating fraud is central to our mission. No system of regulation can ever completely eliminate fraud, but we must always strive for that goal. The process of refining and improving regulatory protections is ongoing and the initiatives outlined above do not mark the end of our efforts. We will continue to work with Congress, the CFTC, SROs and the industry to ensure that customers have justified confidence in the integrity of the U.S. futures markets.

QUESTIONS AND ANSWERS

JULY 17, 2013

Senate Committee on Agriculture, Nutrition & Forestry
Reauthorization of the Commodity Futures Trading Commission
Questions for the Record
July 17, 2013

Chairwoman Stabenow

Dennis Kelleher – Better Markets

1. At the hearing, you discussed the importance of additional resources for the CFTC and the costs of self-funding the agency. Do you believe that self-funding for the CFTC can be done in a way that doesn't harm market liquidity and gives the agency the resources it needs to do its job? Can you provide a detailed assessment of the cost of funding the agency at current levels through industry assessments or fees?

Dan Roth – National Futures Association

1. At the hearing, you discussed how the NFA funds itself. Can you provide a detailed breakdown of this funding stream? Please include information on all assessments and fees that the NFA uses. Also, please provide information on how those funds are collected.

2. There was a call in some of the testimony for this hearing to increase the civil penalties that the CFTC is able to impose for violations of the CEA. Are current penalties out of date? If you do recommend updating them, what would you suggest those look like?

3. You suggest reviewing whether it is a good idea for a joint Broker Dealer/FCM bankruptcy to be administered under SIPA. This is a fairly common criticism of the MF Global Bankruptcy. Who, or what, should determine where that bankruptcy occurs? Some market participants have suggested that splitting joint BD/FCMs into two separate legal entities will reduce risks to commodity customer property, arguing that the costs are worth the benefits. Can you comment on that idea?

4. CME expressed concerns about the CFTC's proposed changes to Rule 1.52 – a rule that governs how SROs monitor FCM compliance with financial and related reporting requirements. In CME's comment letter on this issue from February 2013, they state that the limited regulatory exams that they conduct of FCMs are "not designed, nor should they be, to identify material weaknesses in internal controls over financial reporting. That is the role of the external auditor." Do you share this concern? If the designated SRO, the frontline regulators, can't identify material weaknesses in internal controls, do we have a regulatory accountability gap?

Terry Duffy – CME Group

1. In your written testimony, you expressed concerns about the CFTC's proposed changes to Rule 1.52 – rules that govern how Self-Regulatory Organizations (SROs) monitor compliance by Futures Commission Merchants (FCMs) with financial and related reporting requirements. CME's February 2013 comment letter stated that the limited regulatory exams that CME conducts of FCMs are "not designed, nor should they be, to identify material weaknesses in internal controls over financial reporting. That is the role of the external auditor." If the designated SRO, the frontline regulator, can't identify or isn't even looking for weaknesses in internal controls, is there a regulatory gap? Given the failures of MF Global and Peregrine, where should we look for assurances that auditors of FCMs are doing their job?
2. In your testimony, you discuss the differences between the US and the EU in terms of initial margin coverage and essentially argue that it is okay that these differences exist because they each "achieve the same risk mitigation outcome." Can you explain this more? Won't traders be able to exploit these differences? How exactly are the risk profiles of trades different in the US and the EU such that they warrant different initial margin standards? How much do these differences amount to, in terms of actual cost to traders? You also point out in your testimony that CME manages risk in part by marking-to-market twice a day – are you suggesting that we consider this risk mitigation technique on par with initial margin?

Walt Lukken - Futures Industry Association

1. Are futures/swaps/options customers put at a disadvantage when a joint Broker Dealer/FCM bankruptcy is administered under SIPA? If it is a problem, does this Committee need to act to correct the problem?
2. Some have suggested splitting joint BD/FCMs into two separate legal entities in order to remove risks to commodity customers, arguing that any costs are worth the benefits. Can you comment on this idea?

Gene Guilford – Commodity Markets Oversight Coalition

1. You highlighted concerns with high-frequency trading – do you have specific recommendations on what needs to be done to address your concerns? How do we differentiate between technological advancement and a disruptive force to the markets?

John Heck – National Grain and Feed Association

1. Last year, there were concerns expressed by NGFA and others in the agricultural markets when ICE and CME changed their grain trading hours to allow trading during the release of USDA crop reports. While the situation continues to evolve, and both ICE and CME have made subsequent changes to trading hours, what has been the impact of these changes to date? Is this still a concern and is NFGA still focused on the issue?

Senate Committee on Agriculture, Nutrition & Forestry
Reauthorization of the Commodity Futures Trading Commission
Questions for the Record
July 24, 2013

Senator Cochran

Questions for Mr. Terry Duffy (CME Group)

1) As the Committee with oversight jurisdiction of the CFTC, it is important for us to ensure market participants are protected and are able to hedge market risk in a cost efficient way. The "residual interest" issue is one of significant importance, and it is essential to ensure that this rule does not have unintended consequences. In your opinion, will recent CFTC actions with regard to residual interest adequately protect customers? If this rule had been in place prior to the failures of M.F. Global or Peregrine Financial, is it possible that customers could have had more of their money tied-up with those FCMs when they failed, and thereby lost more money?

2) Many stakeholders have suggested that Congress should consider ways to strengthen protection of customers in the wake of the dramatic MF Global and Peregrine Financial failures. Some of the proposals that have been brought to our attention involve clarifications or changes to the Bankruptcy Code. In your opinion, should Congress consider changes to the Bankruptcy Code in order to better protect customers? If so, please briefly summarize proposed changes to the Bankruptcy Code that you think are most important and explain why they are important.

3) I understand that the CME recently submitted updated deliverable supply data for physical commodities to assist the Commission as it works to propose new position limit rules. In your opinion, how could the CFTC best use this data, and what other suggestions do you have for improving the position limit rulemaking process?

Question for Mr. Dan Roth (National Futures Association)

1) Many stakeholders have suggested that Congress should consider ways to strengthen protection of customers in the wake of the dramatic MF Global and Peregrine Financial failures. Some of the proposals that have been brought to our attention involve clarifications or changes to the Bankruptcy Code. In your opinion, should Congress consider changes to the Bankruptcy Code in order to better protect customers? If so, please briefly summarize proposed changes to the Bankruptcy Code that you think are most important and explain why they are important.

Question for Mr. Adam Cooper (Managed Funds Association)

1) Many stakeholders have suggested that Congress should consider ways to strengthen protection of customers in the wake of the dramatic MF Global and Peregrine Financial failures. Some of the proposals that have been brought to our attention involve clarifications or changes to the Bankruptcy Code. In your opinion, should Congress consider changes to the Bankruptcy Code in order to better protect customers? If so, please briefly summarize proposed changes to the Bankruptcy Code that you think are most important and explain why they are important.

Questions for Mr. Walt Lukken (Futures Industry Association)

1) As the Committee with oversight jurisdiction of the CFTC, it is important for us to ensure market participants are protected and are able to hedge market risk in a cost efficient way. The "residual interest" issue is one of significant importance, and it is essential to ensure that this rule does not have unintended consequences. In your opinion, will recent CFTC actions with regard to residual interest adequately protect customers? If this rule had been in place prior to the failures of M.F. Global or Peregrine Financial, is it possible that customers could have had more of their money tied-up with those FCMs when they failed, and thereby lost more money?

2) Many stakeholders have suggested that Congress should consider ways to strengthen protection of customers in the wake of the dramatic MF Global and Peregrine Financial failures. Some of the proposals that have been brought to our attention involve clarifications or changes to the Bankruptcy Code. In your opinion, should Congress consider changes to the Bankruptcy Code in order to better protect customers? If so, please briefly summarize proposed changes to the Bankruptcy Code that you think are most important and explain why they are important.

3) The CFTC has proposed and in some cases implemented many new rules in the last two years. However, in many instances, the CFTC rules have been accompanied by 11th hour "no-action letter relief" that provides market participants relief from the very rules that the CFTC just ratified. How have these incidences of last minute no action letters impacted the marketplace? How can this process be improved to better serve the marketplace?

Questions for Mr. John Heck (NGFA)

1) As the Committee with oversight jurisdiction of the CFTC, it is important for us to ensure market participants are protected and are able to hedge market risk in a cost efficient way. The "residual interest" issue is one of significant importance, and it is essential to ensure that this rule does not have unintended consequences. In your opinion, will recent CFTC actions with regard to residual interest adequately protect customers? If this rule had been in place prior to the failures of M.F. Global or Peregrine Financial, is it possible that

customers could have had more of their money tied-up with those FCMs when they failed, and thereby lost more money?

2) Many stakeholders have suggested that Congress should consider ways to strengthen protection of customers in the wake of the dramatic MF Global and Peregrine Financial failures. Some of the proposals that have been brought to our attention involve clarifications or changes to the Bankruptcy Code. In your opinion, should Congress consider changes to the Bankruptcy Code in order to better protect customers? If so, please briefly summarize proposed changes to the Bankruptcy Code that you think are most important and explain why they are important.

Senate Committee on Agriculture, Nutrition & Forestry
Reauthorization of the Commodity Futures Trading Commission
July, 17 2013
Questions for the record

Senator Gillibrand

Mr. Daniel J. Roth, President & Chief Executive Officer, National Futures Association

In the wake of the MF Global collapse, the Trustee's report stated that 78 percent of claims were below $100,000. Additionally, the Trustee's report found that, unlike those investments in securities- which are covered by the SIPC insurance fund - commodities customers were left without any insurance to redress losses associated with the illegal transfers within MF Global.

The National Futures Association (NFA) conducted a study of the cost and benefits associated with providing a commodities insurance fund in 1986. But, as you know, there have been many changes to the commodities market since then.

1. I know the Futures Industry Association (FIA) is looking into this issue of a commodities insurance fund. But from your perspective as head of the NFA, what is your timeframe in reexamine the issue of creating an insurance fund for commodities accounts, like we have on the securities side?

2. How could a commodity insurance fund facilitate the distribution of customer assets to clients of a Futures Commission Merchant (FCM) following a FCM bankruptcy, and why couldn't we apply the user-funded SIPC model to commodities?

3. Global financial institutions often have broker-dealers and FCMs, as part of their business models, trading in both commodities and securities, like MF Global. Would a single insurance fund that covers both commodities and securities be more efficient to administer and redress customer losses then separate funds?

Senate Committee on Agriculture, Nutrition & Forestry
Reauthorization of the Commodity Futures Trading Commission
July 17, 2013
Questions for the record

Senator Heitkamp

Mr. Terrence A. Duffy, Executive Chairman and President, CME Group

1.) A number of account holders in North Dakota were victimized by the breach of segregated funds that took place at MF Global. These were farmers that engaged in the futures market to hedge risks, control their exposure to price swings, and lock in strong prices. This is what the market instructed them to do. It was prudent decision making.

    However, instead of being rewarded for their prudent decision, these farmers in North Dakota were introduced to a new risk – the threat of FCM bankruptcy from illegal actions using segregated customer funds. Many growers in North Dakota have had their confidence in the use of futures markets shattered, and rightfully so. Over $1 billion in customer funds went missing for over 18 months. While nearly all of the 27,000 customer claims have been resolved to date by the MF Global Trustee, restitution does not take into account the lost productivity of capital for the duration the funds were missing. And while major progress has been made in making whole the customers whose account dollars were lost, more work is to be done. For every one dollar in customer funds that were stolen by MF Global to cover margin calls on their risky bets, only 89 cents have been returned.

    It is our job on the Agriculture Committee to restore confidence in the markets so that growers can capitalize on the risk mitigation strategies available to them using futures contracts.

    Some have proposed the idea to require segregate customer accounts to be held at the clearing house level. Is this a good idea? Would such an approach introduce new risks for customer accounts?

2.) What additional costs could be expected from a policy to require segregate customer accounts to be held at the clearing house level?

Daniel J. Roth, President and CEO, National Futures Association

1.) In your testimony, you discuss the issue of insurance for segregated account customers. I understand that private sector approaches to this type of insurance product are currently being studied. I also understand that there are some concerns about the ability of a private entity to underwrite this insurance pool. Insurance gives customers confidence, which is among my most important priorities in any policy response to MF Global and Peregrine Financial considered under CEA Reauthorization. Can a private insurance pool for segregated customer accounts be realized that is not detrimental to liquidity and efficiency?

2.) Can you share any thoughts on how this product could be derived?

3.) Is there any role in CEA Reauthorization for advancing a private insurance product for customer accounts?

4.) The SIPC insurance model at the SEC covers customer accounts up to $500,000 from financial harm if a broker dealer fails. The size of the coverage provided by SIPC – $500,000 – would benefit the agricultural customers in my state of North Dakota and would have shielded them from harm from MF Global collapse. I recognize that there are major differences between the futures markets and the securities markets – most notably the difference in size – but I am interested in hearing your thoughts on whether or not a SIPC type model could work for a CFTC customer insurance fund. Can a SIPC type model be crafted that does not result in dramatically increased transactions costs from fees that will inevitably be passed on to customers?

5.) Some have argued that the SIPC is not suited for the commodities markets because the insurance is too slow to pay out. In the event of a collapse, farmers need their funds back right away so they can stay liquid enough to meet their obligations. Could an insurance pool be crafted in way that results in a quick payout?

6.) What are some factors that can delay the transfer of customer funds out of failed companies and back into the customers' bank accounts?

Question for Mr. John M. Heck, Vice President, The Scoular Company

1.) One idea that has been brought to my attention that may speed the return of customer funds when firms declare bankruptcy is a reform to the bankruptcy code. Current ambiguity in the code regarding the priority place of customer accounts versus creditors has resulted in delays in MF Global and Peregrine Financial Group. While the case for customer accounts being the first one out appears clear to me, it is not clear enough to the legal system to prevent earlier precedents from delaying the process. If the law were to require that contracts in CFTC regulated markets include subordination agreements that confirmed in writing that customer accounts were to be the first ones out in the event of bankruptcy – would that create any undesired consequences?

Question for Walter L. Lukken, President and CEO, Future Industry Association,

1.) One idea that has been brought to my attention that may speed the return of customer funds when firms declare bankruptcy is a reform to the bankruptcy code. Current ambiguity in the code regarding the priority place of customer accounts versus creditors has resulted in delays in MF Global and Peregrine Financial Group. While the case for customer accounts being the first one out appears clear to me, it is not clear enough to the legal system to prevent earlier precedents from delaying the process. If the law were to require that contracts in CFTC regulated markets include subordination agreements that confirmed in writing that customer accounts were to be the first ones out in the event of bankruptcy – would that create any undesired consequences?

Senate Committee on Agriculture, Nutrition & Forestry
Reauthorization of the Commodity Futures Trading Commission
Questions for the Record
July 17, 2013
Mr. Terrence A. Duffy
Executive Chairman & President
CME Group, Inc.

Chairwoman Debbie Stabenow

1.) In your written testimony, you expressed concerns about the CFTC's proposed changes to Rule 1.52 – rules that govern how Self-Regulatory Organizations (SROs) monitor compliance by Futures Commission Merchants (FCMs) with financial and related reporting requirements. CME's February 2013 comment letter stated that the limited regulatory exams that CME conducts of FCMs are "not designed, nor should they be, to identify material weaknesses in internal controls over financial reporting. That is the role of the external auditor." If the designated SRO, the frontline regulator, can't identify or isn't even looking for weaknesses in internal controls, is there a regulatory gap? Given the failures of MF Global and Peregrine, where should we look for assurances that auditors of FCMs are doing their job?

CME supports the CFTC's goal of evaluating whether any changes should be made to the risk-based evaluations currently performed on FCMs. CME, in conjunction with the Joint Audit Committee ("JAC") and the CFTC, regularly reviews its procedures and makes changes to those procedures so that they are continually evolving and improving. We are concerned, however, that instead of proposing changes narrowly designed to address perceived weaknesses in the current regulations, the Commission proposes to fundamentally overhaul the nature of the reviews performed by self-regulatory organizations ("SROs") and designated self-regulatory organizations ("DSROs") and, in so doing, threaten the viability of the current regulatory structure.

One of the primary strengths of the current regulatory scheme is that SROs and DSROs play a role distinct from, yet complimentary to, that played by an outside auditor. Rather than simply replicating the work performed by outside auditors, the SROs and DSROs perform limited reviews that focus on particular areas of regulatory concern, including the segregation of customer funds and net capital requirements. The current proposal greatly expands the scope of the regulatory reviews by requiring the examination of the entirety of an FCM's financial statements. This requirement is not only extremely costly, but it imposes such costs without any demonstrated regulatory need.

Any concerns regarding the efficacy of the work performed by an FCM's external auditor should be addressed by tightening the requirements for external auditors, not by expanding the role of the SRO or DSRO. Under Regulation 1.52 as it currently stands, regulatory exams play an important, *but limited*, role. That role is limited to the particular regulatory needs under the CEA. Unlike the role played by an external auditor, the regulatory review is not intended to be relied on by the FCM, its investors, or third parties. CME believes that this structure is appropriate, and opposes any changes to regulation 1.52 which could be read to expand the role and use of the regulatory exams.

2.) In your testimony, you discuss the differences between the US and the EU in terms of initial margin coverage and essentially argue that it is okay that these differences exist because they each "achieve the same risk mitigation outcome." Can you explain this more? Won't traders be able to exploit these differences? How exactly are the risk profiles of trades different in the US and the EU such that they warrant different initial margin standards? How much do these differences amount to, in terms of actual cost to traders? You also point out in your testimony that CME manages risk in part by marking-to-market twice a day – are you suggesting that we consider this risk mitigation technique on par with initial margin?

Due to CME's twice daily mark-to-market rules, CME's minimum margin period of risk of one day effectively covers twice the potential exposure of a portfolio in a given day. CFTC rules set a floor for the amount of initial margin that clearinghouses must collect. CME's clearing house determines margin levels by risk management policies and procedures designed to account for the actual risk profile of the product -- its underlying volatility and liquidation risk -- not the CFTC minimum. In fact, many of our financial futures products require initial margin based on a two-day volatility measure, in excess of the CFTC's regulatory minimum for futures.

This flexible approach to initial margin levels has been validated repeatedly during periods of market stress, including during the liquidation of house and customer portfolios where necessary. ESMA (the European Securities and Markets Authority) has imposed 2-day minimum initial margin coverage. We believe that the application of a 2-day minimum for all US futures contracts is both inappropriate based on market characteristics and unnecessarily costly to end users, including small agricultural producers who use the markets as a necessary hedge to their business risks.

Twice daily marking to market is on par, if not superior, to a two day initial margin period of risk. A two day period of risk requires initial margin of approximately 1.4 times a one day period of risk. In liquid futures markets, twice daily marking to market permits clearing houses to liquidate positions after half a trading day has passed. In effect, twice daily marks is equivalent to collecting two times the initial margin in a system that only marks to market once a day.

Ranking Member Thad Cochran

1.) As the Committee with oversight jurisdiction of the CFTC, it is important for us to ensure market participants are protected and are able to hedge market risk in a cost efficient way. The "residual interest" issue is one of significant importance, and it is essential to ensure that this rule does not have unintended consequences. In your opinion, will recent CFTC actions with regard to residual interest adequately protect customers? If this rule had been in place prior to the failures of M.F. Global or Peregrine Financial, is it possible that customers could have had more of their money tied-up with those FCMs when they failed, and thereby lost more money?

CME is fully committed to protecting customers against the full range of FCM conduct that may cause customer harm. But, it is important to weigh the costs and consequences of each protective measure against the benefit to the customers. If a "protective" measure is so expensive or if its impact on market structure is so severe that customers cannot effectively use futures markets to mitigate risk or discover prices, the reason to implement that measure needs to be reexamined.

The Commission's residual interest proposal, if adopted, will have unintended negative consequences for our customers, especially those who use our agricultural markets, and for many of our clearing members and non-clearing FCMs that provide market access to those customers. It is also likely that this proposal will raise the overall level of risk to all participants in our markets.

First, it does not appear that any system currently exists or could be constructed in the near future that will permit FCMs to accurately calculate customer margin deficiencies, continuously, in real time.[1] Without access to such information, an FCM must either maintain a substantial residual interest in the various segregated fund pools or require customers to significantly over-collateralize their accounts.

Assuming that a customer's required initial margin covers a one day move with a 99% level of confidence based on recent historical precedents and that one could disregard the fact that this level of confidence suggests that the loss will exceed the initial margin requirement once every 200 trading days, an FCM would be well advised to require each customer to deposit excess collateral at least equal to the required collateral. We believe that this will be a significant and unnecessary drain on liquidity that will make trading significantly more expensive for customers to hedge financial or commercial risks.

If FCMs respond to the proposed rule by demanding excess collateral, the proposal will have the ill effect of forcing customers, who are actively trying to avoid fellow customer risk and potential misuse of their funds at FCMs, to put more money and collateral in the hands of FCMs. This means that there would be more customer money at risk if another FCM were to disregard the CEA and CFTC's regulations precluding FCMs from using customer funds for their own purposes. For this reason alone, we believe that this proposal does not meet the necessary cost benefit test. Customers will be required to place substantial additional funds at risk for the exact type of misuse of funds that severely injured them in the MF Global and Peregrine Financial matters. The goal is to save them from fellow customer risk that might arise if customers defaulted on margin calls to an extent greater than could be covered by their mutual clearing

[1] For example, as an operational matter, today, FCMs are not able to calculate margin deficits at all times during the day and not even at the intra-day settlement cycles. The daily intra-day call made by the CME Clearing is an estimate of the day's market movements. Clearing members do not capture those intra-day estimates in their internal systems or systems interfacing with the CME Clearing. The firms would not be able to reconcile the clearinghouses intraday calculation to their individual customers' margin obligations, or predict how much of a potential margin obligation a particular customer may need to prefund costs and limit the activities of market makers. Ultimately, this increased cost to risk manage will get passed on to consumers in the form of higher commodity prices.

member's capital—a circumstance that has never occurred. We hope that customer confidence in the system in this regard will improve as market participants become more fully aware of the effectiveness of the SRO rules enhancing transparency and oversight of funds held at the FCM level discussed previously, and will, on their own volition, be willing to hold more excess margin with their FCMs.

To the extent that the larger FCMs are able to use their own funds to fulfill the residual interest obligations under the proposed rules, we would expect this to result in significant competitive consolidation in the FCM community. Generally, the mid-size and smaller FCMs will not have the capital to cover the residual interest requirement, and will have no choice but to require their customers to pre-fund potential margin obligations. For the segment of customers attractive to the larger FCMs, those customers would likely transfer their accounts from the smaller FCMs to the larger ones because the cost of trading will be reduced. This may make it even more difficult for the mid-size and smaller firms to compete having a smaller and less diversified customer base.

We believe such consolidation could have a profound impact in the agricultural markets. Specifically, agricultural customers—farmers, ranchers and other commercial users —likely will not be able to transfer to the larger FCMs because they do not fit their customer profile. In our view, the cost of doing business in futures markets will increase measurably for this important segment of market participants because they will have no choice but to stay with FCMs that will require pre-funding of margin accounts, assuming that at least some of those FCMs stay in business.

Significantly, consolidation among FCMs, in our view, actually increases systemic risk in the system by concentrating risk among fewer market participants. Increased systemic risk should never be a consequence of regulation. We note that we already have seen a dramatic decline in the FCM community in the last 5 years as a result of the changing regulatory landscape and macro-economic conditions.[2]

2.) Many stakeholders have suggested that Congress should consider ways to strengthen protection of customers in the wake of the dramatic MF Global and Peregrine Financial failures. Some of the proposals that have been brought to our attention involve clarifications or changes to the Bankruptcy Code. In your opinion, should Congress consider changes to the Bankruptcy Code in order to better protect customers? If so, please briefly summarize proposed changes to the Bankruptcy Code that you think are most important and explain why they are important.

We believe that Congress could further enhance customer protections through amendments to the Bankruptcy Code. Potential amendments range from fundamental changes that would facilitate individual segregation of customer property, as an option should an FCM choose to offer it, to narrower revisions that would enhance a clearing house's ability to promptly transfer positions of non-defaulting customers. While amending the Bankruptcy Code is a significant undertaking,

[2] Based on our estimates, the industry has lost between 40-50 FCMs since December 2007.

CME Group believes in light of recent experience that modification to the bankruptcy regime would benefit customers and the market as a whole. While we have not come to a final conclusion on a specific amendment that we would support, we have advocated for Bankruptcy Code changes to protect derivatives customers and the integrity of regulated clearing houses in the event of an FCM bankruptcy. In the case of the MF Global bankruptcy, clearing houses were not able to transfer customer positions and related collateral because there was a shortfall in customer property and the bankruptcy code precluded transfers of positions and collateral without the consent of the trustee and the court. As a result, customers were locked into positions and unwarranted volatility was injected into the markets. MF Global customers had to wait up to 5 days to transfer positions and collateral and then clearing houses were only permitted by the bankruptcy court to initially transfer approximately 65% of customer collateral. If CME had not agreed to assume responsibility for any excess transfers, it is not clear that the partial transfer could have been achieved in this time frame. This outcome unjustifiably put customers at risk despite the fact the clearing house had possession of 100% of customer collateral deposited with them.

An amendment to the Bankruptcy Code would enable immediate transfer of the positions and supporting collateral of non-defaulting customers to an alternative FCM, enabling customers to continue to liquidate positions and otherwise participate in the markets and not lose the ability to manage their risk. Such an amendment would permit a clearing house that holds full collateral for the non-defaulting customers of a failed clearing member to immediately transfer those customers' positions, along with the required collateral for those positions, to other clearing members. Current law requires these customer positions to be frozen along with all other assets of the failed FCM and distributed pro rata only through court order. The legislation would effectively remove customer positions and associated collateral held at a clearing house from the bankruptcy estate and the pro rata distribution scheme. Remaining customer property at the clearing house and held at the FCM level would continue to be treated as "customer property" and remain part of the bankruptcy estate and subject to court ordered pro rata distribution.

3.) I understand that the CME recently submitted updated deliverable supply data for physical commodities to assist the Commission as it works to propose new position limit rules. In your opinion, how could the CFTC best use this data, and what other suggestions do you have for improving the position limit rulemaking process?

The CFTC currently sets position limits in the delivery period at 25% of the visible deliverable supply. Unfortunately, the Commission has not revised the deliverable supply calculations in a very long time, despite urgings from the industry.

To ensure that the CFTC relies upon accurate and current market data in its analysis, CME recently submitted updated deliverable supply data for physical commodities – energies, metals and agriculture products. The Commission should rely on these updated data if it undertakes to propose a new position limit rule.

We impose position limits in the spot months for many of our own markets and an early warning system of accountability levels for all other trading months. Accountability levels were specifically endorsed as an appropriate process by Dodd-Frank. As amended by Dodd-Frank, section 5(d) establishes "core principles" for designated contract markets, which make it abundantly clear that such discretion pertains to the choice of hard limits or accountability levels. The CFTC simply ignored that provision and insisted on hard limits for all months, including the non-spot months, based on its assertion that Dodd-Frank mandated those limits even if they were not found to be necessary.

Last year, a U.S. District Court Judge found the CFTC improperly concluded that it had a mandate post-Dodd-Frank to impose limits under any circumstances. The CFTC is appealing that decision. CME recently joined other market participants asking the court to direct the CFTC to determine that position limits are necessary and appropriate before imposing them.

Senator Heidi Heitkamp

1.) A number of account holders in North Dakota were victimized by the breach of segregated funds that took place at MF Global. These were farmers that engaged in the futures market to hedge risks, control their exposure to price swings, and lock in strong prices. This is what the market instructed them to do. It was prudent decision making.

However, instead of being rewarded for their prudent decision, these farmers in North Dakota were introduced to a new risk – the threat of FCM bankruptcy from illegal actions using segregated customer funds. Many growers in North Dakota have had their confidence in the use of futures markets shattered, and rightfully so. Over $1 billion in customer funds went missing for over 18 months. While nearly all of the 27,000 customer claims have been resolved to date by the MF Global Trustee, restitution does not take into account the lost productivity of capital for the duration the funds were missing. And while major progress has been made in making whole the customers whose account dollars were lost, more work is to be done. For every one dollar in customer funds that were stolen by MF Global to cover margin calls on their risky bets, only 89 cents have been returned.

It is our job on the Agriculture Committee to restore confidence in the markets so that growers can capitalize on the risk mitigation strategies available to them using futures contracts.

Some have proposed the idea to require segregate customer accounts to be held at the clearing house level. Is this a good idea? Would such an approach introduce new risks for customer accounts?

Notwithstanding the fact that MFG's misconduct was the cause of the shortfall in customer segregated funds, CME Group's efforts in the wake of these events speak to the level of our commitment to ensuring our customers' confidence in our markets:

- Guarantee for SIPC Trustee. We made an unprecedented guarantee of $550 million to the SIPC Trustee in order to accelerate the distribution of funds to customers.

- CME Trust Pledge. CME Trust pledged virtually all of its capital - $50 million – to cover CME Group customer losses due to MFG's misuse of customer funds.

- CME Group Family Farmer and Rancher Protection Fund. On April 2, 2012, CME Group launched the CME Group Family Farmer and Rancher Protection Fund to protect family farmers, family ranchers and their cooperatives against losses of up to $25,000 per participant in the event of shortfalls in segregated funds. Farming and ranching cooperatives also will be eligible for up to $100,000 per cooperative.

  The Protection Fund was made available to PFG customers and more than $2 million were distributed.

- Agreement with MFG Trustee. On August 12, 2012, the Bankruptcy Court approved the agreement between the SIPC Trustee for MFG and CME Group that provides for the distribution of approximately $130 million of MFG proprietary assets, on which CME and its members held perfected security interests, to MFG customers.

While some have proposed that segregated customer funds be held at the clearinghouse level, we continue to support the FCM operating model and work with our clearing members and customers to improve that model. We believe that improving the FCM model is necessary to restore public confidence in the derivatives markets while preserving the operating model for the vast majority of FCMs who respect and comply with the rules. As an industry, we have adopted a number of initiatives in furtherance of this goal:

- Increased surprise reviews of customer segregated funds;

- Daily segregation reporting by all FCMs;

- Bi-monthly reporting on investment of segregated funds;

- Periodic electronic confirmation of customer segregation balances from firms via e-confirm system;

- New rules providing for daily feeds of cash and securities balances for all customer accounts at banks;

- CEO/CFO signoffs of customer segregated fund distributions (Corzine rule).

2.) What additional costs could be expected from a policy to require segregate customer accounts to be held at the clearing house level?

The creation of individual segregated accounts at the clearing house level is likely to be prohibitively expensive for the farmers and ranchers who use our markets to hedge. However, if individual segregation were optional, large accounts could make use of the option and smaller customers would thereby be protected against being caught up in the failure of one of those large accounts.

Senate Committee on Agriculture, Nutrition & Forestry
Reauthorization of the Commodity Futures Trading Commission
Questions for the Record
July 17, 2013
Mr. Gene Guilford

Chairwoman Debbie Stabenow

1.) You highlighted concerns with high-frequency trading – do you have specific recommendations on what needs to be done to address your concerns? How do we differentiate between technological advancement and a disruptive force to the markets?

(Response Dated August 23, 2013)

Dear Chairwoman Stabenow:

Thank you for the question regarding high-frequency trading (HFT)[1] and for the recent opportunity to testify before the Committee on the Reauthorization of the Commodity Futures Trading Commission (CFTC) and policies that affect the Commodity Markets Oversight Coalition, its constituent organizations and their members.

Question: ***Do you have specific recommendations on what needs to be done to address your concerns?***

Our recommendations to the committee are as follows:[2]

- Provide the CFTC with explicit authority to promulgate rules and regulations governing HFT in order to prevent manipulation, disruptive trading and anti-competitive behavior, and permit the CFTC to (a) ban high-frequency traders found to be in violation of said rules and regulations, and (b) prohibit the use of certain algorithmic trading strategies.
- Require greater access to HFT terminals and the creation of across-the board standards in order to encourage competition, growth and innovation; increase transparency and system reliability and security; and lower the barrier of entry to the HFT market.
- Require testing standards and built-in safeguards in exchange price quoting systems and algorithmic trading programs such as HFT in order to prevent unexpected crashes, erratic or unintended trading by computer glitches or user error, security breaches by computer hackers and erroneous responses between various automated systems that can result in false signals or otherwise disrupt markets and harm investor confidence.

[1] The term "High-Frequency Trading" or HFT has become a catch-all term referring to any use of increasingly complex technologies such as automated computer algorithms to rapidly engage in the trading of securities, commodities futures and other financial instruments.
[2] In addition to our recommendations, the committee should examine the proposals included in the "Protection from Rogue Oil Traders Engaging in Computerized Trading Act" or simply, the PROTECT Act (H.R.2292) introduced on June 6, 2013 by then-Congressman Ed Markey of Massachusetts (now a U.S. Senator).

- Codify in U.S. law CME Rule 514.A, which aims to prevent "spoofing" or the dissemination of false, misleading or inaccurate quotes designed confuse other traders.
- Ensure an adequate ratio between HFT-affiliated orders and executed transactions in order to deter the practice of "quote stuffing." The order-transaction ratio should be determined separately for each financial instrument based on the volume of orders and transactions per month. An order-transaction ratio is considered appropriate if it is "economically comprehensible" in light of available liquidity, specific market conditions or the function of the participant.
- Require the CFTC to harmonize HFT-related rules and regulations with the Securities & Exchange Commission (SEC) as well as foreign and international financial regulators.
- Increase overall penalties for violations of the Commodity Exchange Act (as was recommended in my testimony) and consider additional authority that would allow the CFTC to establish fines that are designed to curb adverse HFT-specific behaviors.[3]

Because the Senate Agriculture Committee has exclusive jurisdiction over the CFTC but not the SEC, we encourage the committee to work closely with the Senate Banking Committee to provide both regulators with comparable authority to address concerns regarding HFT.

We further encourage Congress to closely monitor legislative bodies in Europe and elsewhere as they consider policies designed to strengthen oversight and regulation of HFT and other emerging market technologies. This includes a newly enacted German law, the "Act for the Prevention of Risks and the Abuse of High Frequency Trading"[4] adopted by the German Parliament on February 18, 2013. This newly enacted law requires the licensing, regulation and supervision of HFT firms, establishes conduct of business rules and organizational standards and safeguards, and prohibits or deters disruptive trading practices.

On October 26, 2012, the European Parliament passed the revised Market in Financial Instruments Directive (MiFID II). HFT is addressed in Articles 51 and 51a.[5] Negotiations are now underway between the European Parliament, the European Commission and the European Council. A final MiFID II is expected by the end of 2013.[6] As these negotiations continue and as the CFTC continues to coordinate with European counterparts on cross-border issues, questions will certainly be raised about the status of U.S. efforts to regulate HFT. We greatly encourage the Congress to work with the CFTC to ensure enactment of comparable oversight of HFT markets in order to better fulfill the Dodd-Frank requirement that "comprehensive and comparable oversight" exist in transatlantic derivatives regulations. Committee staff should closely monitor the negotiations between European institutions regarding the HFT provisions in MidFID II and open a dialogue with Parliamentary representatives led by Economic and Monetary Affairs Committee Chairwoman Sharon Bowles.

---

[3] For example, in order to discourage the programming of an algorithm to allow for more than 10,000 trades in one second only to cancel the same within two seconds, or a HFT program whose aggregate daily trades exceed 100,000 buy, sell and subsequent cancel orders that occur within five seconds of each other, a fine could be established that is equal to at least 0.03% of the value of the trades.

[4] In German: *Entwurf eines Gesetzes zur Vermeidung von Gefahren und Missbräuchen im Hochfrequenzhandel*

[5] http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2012-406#BKMD-7

[6] The same time as the expiration of the compliance deadline for non-U.S. persons with CFTC's cross-border rules.

***Question:* How do we differentiate between technological advancement and a disruptive force to the markets?**

Technological advancements can have positive and negative outcomes. What matters is how that technology is deployed and whether or not it serves the public interest. In recent years, financial markets, including commodities markets, have moved from traditional "open outcry" trading pits to computerized trading platforms, digital order placement and trade execution systems, and other innovative technologies. When properly regulated and utilized, these technologies can improve investor confidence and increase market efficiency, liquidity and overall stability.

Unfortunately, without proper oversight, negative outcomes can result. HFT is now a dominant force in the futures markets, comprising half of overall trading volume according to recent CFTC estimates. Yet, HFT lacks adequate "rules of the road" to ensure it is a positive force in the marketplace. Our coalition has identified several areas below where problems have been found to exist with HFT in particular and the shift towards computerized trading in general.

Manipulative or Disruptive Trading

In HFT, traders use computer algorithms to execute complex trading strategies at lightning-fast speeds. These trading strategies can be quite aggressive, disruptive and even manipulative. This includes the trading strategies often-called "quote stuffing," "whale hunting" and "spoofing."

Quote Stuffing

Quote stuffing, as explained by former Goldman Sachs banker Wallace Turbeville, is a practice by which HFTs "flood an exchange or other transaction-matching venue with quotes to buy or sell in order to slow down the venue's processing times." HFTs do this, he explains, in order to curtail potential competition and more efficiently deploy trading strategies designed to "exploit the difference in price between the exchange and another that is operating normally."[7]

Whale Hunting

When "whale hunting," the HFT pings the market to find a "price insensitive" market participant "with a large position that [the whale] is in the process of accumulating or liquidating." The HFT program then targets that trader and meets the entirety of the bid offers in order to crowd out the position and "become the sole and dominant purchaser," thereby establishing "a narrow band of absolute power controlling the particular securities or derivatives that the whale seeks to buy or sell."[8] Aggressive trading of this kind should certainly raise alarm bells among policy makers.

Spoofing

Spoofing is a practice the CFTC has already taken some action against using newly acquired anti-disruptive trading authority provided by Congress under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[9] On July 22, 2013, the CFTC ordered Panther Energy Trading, LLC and its owner Michael J. Coscia to pay $2.8 million in fines and banned them from trading for 12 months for "spoofing" in various commodity futures contracts.[10]

---

[7] Turbeville, Wallace, "Cracks in the Pipeline Part Two: High Frequency Trading," *Demos*, March 8, 2013, p. 10. Available at: http://www.demos.org/publication/cracks-pipeline-part-two-high-frequency-trading.
[8] *Ibid.* p. 11.
[9] Pub.L. 111-203, §747.
[10] CFTC Press Release, July 22, 2013. Available at: http://www.cftc.gov/PressRoom/PressReleases/pr6649-13.

Panther had used a computer-based trading algorithm to place and quickly cancel bids and offers in futures contracts for commodities including crude oil. According to the CFTC, they hoped to "give the market the impression that there was significant buying interest, which suggested that prices would soon rise, raising the likelihood that other market participants would buy from the small order Corsica and Panther were then offering to sell." In addition to the CFTC fine Panther and Corscia were also ordered to pay an additional $903,000 in fines to the United Kingdom Financial Services Authority (FSA) and $800,000 in fines to the Chicago Mercantile Exchange (CME), for a total of $4.5 million in fines.

Fairness & Competition

When compared to more traditional trading methods, HFT has been found to have advantageous profit-to- risk ratios. A recent CFTC report published in December found that "the magnitude and consistency of [HFT] profits as well as their risk-return tradeoff demonstrate unusually strong performance."[11] The report goes on to say "the profitability of HFTs depends on their relative speed: in a winner-takes-all market, profits accrue almost entirely to the fastest." In other words, speed equals profits in the jungles that are the financial markets. HFTs are "cheetahs" and the fastest among them takes home the biggest paycheck.

Because HFT promises greater profit with less risk and because it enjoys a unique and profitable advantage over other traders, traditional market participants may seek to avail themselves of the same benefits. Unfortunately, the CFTC study doesn't give them much reason to hope. While there are no institutional barriers to entry, the speed and complexity of HFT seem to challenge non-HFT participants looking to break in. The CFTC noted that "new entrants have a higher propensity to under-perform and exit, and the fastest firms (in absolute and in relative terms) earn the highest profits." [12]

Also, it is no secret that insider trading on non-governmental information is legal in the commodity markets. As in any financial market, investors seek to take market positions based on actionable information as quickly as possible. We are concerned that the speed by which this information can be obtained and acted on by HFT could significantly disadvantage other traders and overall market integrity. Suppose, for example, that an energy firm plans to announce the deployment of a new drilling technology with the potential lower production costs. An HFT firm, having paid millions of dollars for advance access to this information, may develop a trading algorithm designed to place millions of orders seconds or fractions of a second ahead of the official announcement and stand to make a considerable profit.

Market Integrity & Systemic Risk

We have concerns that poorly designed or misused electronic trading systems pose significant systemic risks and can jeopardize market integrity and investor confidence. Improper trading parameters or programming errors within HFT algorithms can result in errors. It could cause other HFT programs to mimic or otherwise overact to erroneous behavior or misinformation. Some of these events are referred to as "flash crashes." The most well-known flash crash occurred on May 6, 2010. Federal regulators have determined that HFT activity was at least in

[11] Baron, Matthew, et. al., "The Trading Profits of High Frequency Traders," Commodity Futures Trading Commission, November 2012, p.36 (published on December 3, 2012).
[12] *Ibid.*, p. 1.

part responsible for causing the Dow Jones Industrial Average to drop 700 points in twenty minutes and the S&P 500 to fall by 10 percent within fifteen minutes.[13]

Consider these recent "technological breakdowns," three of which occurred in the last month:

- August 1, 2012 - Knight Capital Group, Inc. lost almost half a billion dollars thanks to a malfunction in one of its trading algorithms. Knight Capital never fully recovered from the loss. Earlier this summer the firm announced a merger with Getco, LLC, forming KCG Holdings, one of the most powerful HFT firms in the market today.[14]
- April 23, 2013 - A hacked *Associated Press* twitter feed erroneously reported that President Obama was injured in an explosion at the White House. It is believed that HFT pattern recognition software designed to monitor the internet including social media for actionable information initiated trades based on the false *AP* tweet. As a result, the Dow plunged more than 140 points, the S&P 500 lost $121 billion of its value and crude oil fell by 1 percent in under two minutes.[15]
- April 25, 2013 - Two days later, the Chicago Board Options Exchange (CBOE) went dark for three-and-a-half hours due to a software glitch.[16]
- August 6, 2013 – Software problems caused the BATS BZX exchange to go dark between 1:15pm and 2pm. Later that day, its rival Direct Edge began experiencing computer glitches associated with ticker symbols between the letters SPYV and TNC. Together these exchanges represent over 20 percent of all U.S. stock trading volumes.[17]
- August 20, 2013 – Three days ago, a programming error at by automated trading software at Goldman Sachs mistakenly initiated a flood of single-stock and options trades. The error may end up costing the firm an estimated $100 million in losses.[18]
- August 22, 2013 – Yesterday, with little warning, errors in the automated price quoting forced the Nasdaq to shut down for more than three hours. The "flash freeze" affected more than 3,000 stocks including Facebook, Apple and Google.[19]

As you can see, erroneous market signals, whether intentional or unintentional, have already been shown to have serious consequences for the welfare of non-HFT market participants, market integrity and the overall stability and security of U.S. and global economies.

---

[13] See the September 30, 2010 Joint CFTC and SEC report at http://www.sec.gov/news/studies/2010/marketevents-report.pdf.

[14] See the official July 1, 2013 Press Release at http://bit.ly/174s4Gp.

[15] Farrell, Maureen, "High speed trading fueld Twitter flash crash," *CNN Money*, April 24, 2013. Available at: http://money.cnn.com/2013/04/24/investing/twitter-flash-crash/index.html.

[16] Saphir, Ann, et.al., "CBOE dark for much of day due to software glitch," *Reuters*, April 25, 2013. Available at: http://www.reuters.com/article/2013/04/25/us-cboe-delay-idUSBRE93O0XV20130425.

[17] Dietrich, Chris and Jacob Bunge, "System Problems Hit BATS, Direct Edge," *Wall Street Journal*, August 6, 2013. Available at: http://on.wsj.com/17R2ClL.

[18] Jeffery, Adam, "Goldman trading glitch could cost more than $100 million," *CNBC*, August 20, 2013. Available at: http://www.cnbc.com/id/100976404.

[19] Yang, Jia Lynn and Danielle Douglas, "Nasdaq resumes trading after technical glitch," *Washington Post*, August 22, 2013. Available at: http://wapo.st/17QZOVL.

We are also concerned about the effect that HFT has on market liquidity and the price discovery mechanism. While HFT proponents commonly argue that it increases market liquidity and stability, Turbeville questions this assertion in his aforementioned report. He finds that HFT actually (1) consumes liquidity during times of market stress when it is most needed; (2) makes markets inefficient and "subverts the essential price discovery function of the marketplace;" and (3) decreases overall market transparency by driving non-HFT market participants and related transactions to less regulated off-exchange trading environments.[20]

Citing a number of market disruptions believed to have been caused by HFTs, Turbeville says they have been shown to be incapable of the "flexibility" of perception enjoyed by human traders. As a result, they can send false signals that are misinterpreted by other market participants and cause markets to overreact. "Nuanced interpretation is a constant problem for HFT with costly consequences to the economy," he says. HFT-driven market events have already been shown to cause swings in the price of securities, futures and the value of indices. The stakes are even greater in the commodities markets, wherein a major surge in the price of oil or wheat could increase energy or food prices for millions of consumers.

Earlier this year, researchers from the Zurich Technological Institute, the University of Geneva and the United Nations Conference on Trade and Development published research on this question as it applies to the US and European commodities and financial futures markets.[21] They found that HFT causes multiple price changes for no reason other than that their activities were all triggered by a single price change that was not found to have any correlation to underlying market fundamentals. In other words, HFTs cause volatility.

They also found that these induced price changes are prevalent. In each of the crude oil (Brent and WTI), CBOT corn, wheat and soybeans and E-mini Stock futures markets, over half of the price changes are caused by this activity, with episodes ranging as high as 85%. They conclude that this phenomenon "makes the price formation process less efficient and more prone to instability." Interestingly, while their methodology was designed to measure short term volatility, they applied it over a longer period and found similar results relating to "price bubbles."

A July 24, 2013 *CNBC* article also reported that fears of HFT-driven "flash crashes" have been growing among investors in the crude oil markets.[22] These fears are not unfounded. As recently as September 17, 2012, a historic flurry of high-volume trading believed to be the result of HFT activity shocked veteran traders and sent the oil market tumbling despite the lack of any meaningful news that would affect fundamentals.[23] The *Wall Street Journal* also reported in October of 2012 that similar fears exist among traders in the natural gas market.[24]

---

[20] Turbebeville, *p. 2*

[21] Sornette, Didier, "Quantification of the High Level of Endogeneity and of Structural Regime Shifts in Commodity Markets," (Preprinted discussion paper submitted to the United Nations Conference on Trade and Development, March 21, 2013) Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2237392.

[22] Jegarajah, Sri, "Four-week rally in US crude rekindles 'flash crash' fears," *CNBC*, July 24, 2013. Available at: http://www.cnbc.com/id/100902539.

[23] Schneyer, Joshua and Jeanine Prezioso, "Rapid plunge in oil futures leaves traders guessing," *Reuters*, September 17, 2012. Available at http://www.reuters.com/article/2012/09/17/us-markets-oil-idUSBRE88G02F20120917.

[24] Rogow, Geoffrey, "'Banging the Beehive' Explained" (Video), *Wall Street Journal*, October 16, 2012. Available at http://on.wsj.com/19zH13A.

Cybersecurity
Congress should explore the possibility that terrorists and other enemies of the United States, anarchists, hackers, disgruntled employees, or mentally unstable traders may obtain and exercise malicious control over order-generating/routing systems. While we cannot point to any specific case in which the security of U.S. financial markets may have been directly targeted by these nefarious actors, we believe it would be prudent for Congress to examine the issue, explore whether or not appropriate safeguards exist and ensure necessary oversight is being conducted by relevant U.S. and international agencies. This should also include an investigation into other possible disruptions to the security or operability of electronic trading systems, such as power outages and natural disasters.

Conclusion
The integrity of and confidence in the commodity markets should be a top priority for Congress and the CFTC. As mentioned in my testimony, the commodity futures, options and swaps markets were not designed to be purely financial markets. Rather, they were established to serve the risk management and price discovery needs of bona fide commercial hedgers. The committee should be mindful of this as it considers policy questions related to HFT and other questions regarding the integrity and proper functioning of the commodity markets.

Congress should not stop the introduction of new technology. Congress should stop the use of these new technologies to carry out false, misleading, non-competitive, disruptive or manipulative trading practices. Lawmakers should take necessary steps to ensure that computerized trading serves to improve market transparency, stability and confidence – not the other way around. CFTC reauthorization may provide Congress just such an opportunity. We look forward to working with the committee as it moves forward.

My contact information is below should you require additional information. You may also reach out to CMOC co-chairs Jim Collura (jim.collura@nefi.com) or Sherri Stone (sstone@pmaa.org).

Sincerely,

Mr. Gene Guilford
On behalf of the Commodity Markets Oversight Coalition
gguilfords@comcast.net
(860) 989-0756

Senate Committee on Agriculture, Nutrition & Forestry
Reauthorization of the Commodity Futures Trading Commission
Hearing: July 17, 2013
Question for the Record
Mr. Dennis M. Kelleher
President and CEO
Better Markets, Inc.

Chairwoman Debbie Stabenow,

1) At the hearing, you discussed the importance of additional resources for the CFTC and the costs of self-funding the agency. Do you believe that self-funding for the CFTC can be done in a way that doesn't harm market liquidity and gives the agency the resources it needs to do its job? Can you provide a detailed assessment of the cost of funding the agency at current levels through industry assessments or fees?

Summary

The CFTC is now responsible for the regulation and oversight of the vast, complex swaps, futures, and options markets. Given that the last crisis was incubated and spread throughout the globe via these markets, the CFTC is unquestionably among the most important financial regulators and essential to protecting the American people from another financial collapse. Yet, its funding levels are grossly insufficient to do its job and have not increased in proportion to the magnitude of the new duties it has been charged with in the Dodd-Frank Consumer Protection and Wall Street Regulation Act ("Dodd-Frank Act").

While many essential government services have to be funded by the taxpayers, that is not the case for the CFTC. As the analysis below shows, the CFTC's funding needs could be **fully met**, without recourse to taxpayer funds, by imposing a fee of as little as $1 per million dollars of **notional** value on each swap contract, and just 28¢ per million dollars of notional value on each futures and options contract transacted in the United States (for each party to the swap). This would be a 0.0001% transaction fee, a hundredth of a basis point, on swaps, and a fraction of that amount for futures and options.

Such a small CFTC funding fee would not harm market liquidity. For instance, according to DTCC data, the average interest rate swap transaction has a notional size of approximately $58 million.[1] The private execution cost for such a swap is typically around $1,000.[2] Under the proposal here, the incremental CFTC funding fee would be $58.

---

1 Calculated from a random sample of days in July and August 2013 using data taken from https://rtdata.dtcc.com/gtr/inquiry.do.

2 Based on discussions with swap market participants.

Similarly, a farmer with 500 acres of corn crop could hedge his entire yield (approximately 75000 bushels) on the CME with 15 corn futures contracts.[3] The CME execution fees on this order would exceed $10, yet the incremental CFTC funding fee would be just 10¢.[4]

Given its small size, a CFTC funding fee of $1 per $1 million of notional swaps and 28¢ per $1 million of notional futures and options would have no noticeable impact on liquidity and would be highly unlikely to influence any trading decisions. The decision to hedge or not can make a difference of tens if not hundreds of thousands of dollars to an individual farmer or business. It is hard to imagine any such true end users or their customer-facilitating brokers being driven away from the market by a dime fee.

In fact, academic literature supports the notion that *de minimis* financial transaction fees have a negligible or zero impact on liquidity. For instance, recent research from the University of Massachusetts found that developed financial markets tend to tolerate transaction fees of up to 50 basis points with little or no impact on liquidity.[5] The CFTC funding fee proposed here would be a miniscule fraction of that amount.[6]

It is important to remember that the CFTC is the only financial regulator that does not impose fees to fund itself; put another way, the current funding mechanism of the CFTC makes it the only financial regulator that burdens the taxpayer. And, the CFTC funding proposal here would be, by far, the smallest fee among the financial regulators. For example, the SEC currently charges user fees of $17.40 per million dollars of securities to raise over $1 billion annually in revenues.[7] (And, even this sized fee has not impaired liquidity.) Thus, the proposal we are advancing is a small fee which would raise a modest amount of revenue necessary to adequately fund a hugely important regulator, while not harming liquidity.

---

3 Using yield data from USDA to estimate a 150 bushel per acre yield.

4 The CME pricing schedule is quite complicated with multiple price points depending upon whether the trader is a member or non member, and whether the trade is a brokered trade or a proprietary trade. Nevertheless, it is not hard to see that a typical transaction costs many multiples of what the proposed transaction fee would amount to. For a Eurodollar Contract (and most of the financial contracts) the CME charges the broker 5 cents and the customer 5 – 20 cents depending upon the size of the customer. For an agricultural commodity contract the CME charges the broker 6 cents and the customer between 10 and 90 cents.

5 Robert Pollin & James Heintz, *Transaction Costs, Trading Elasticities and the Revenue Potential of Financial Transaction Taxes for the United States*, Political Econ. Research Inst., Univ. of Mass., Dec. 2011, *available at* http://www.peri.umass.edu/fileadmin/pdf/research_brief/PERI_FTT_Research_Brief.pdf.

6 There will, however, no doubt that some who claim – without basis or evidence -- that even a miniscule CFTC funding fee will harm markets. If these unfounded claims were to cause concern, there is no reason that Congress could not phase in this fee, starting, for example, with a fee in the first year of just 50¢ per $1 million of notional value, which would be a 0.00005% transaction fee. This would be sufficient to cover half of the CFTC's current annual budget needs. The second year this fee could go to 75 cents and then to $1 per $1 million of notional in the third year of the phase in. At any one of these 3 levels, this CFTC funding fee would represent a tiny addition to existing user fees levied by all the for-profit exchanges.

7 SEC Press Release 2013-74, *Fee Rate Advisory #3 for Fiscal Year 2013*, Apr. 25, 2013, http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514024#.UhJdOmTTUxQ.

The CFTC's Responsibilities Have Increased Massively

The role of the CFTC in today's U.S. and global derivatives and commodities markets is far greater than at any point in its history. Until the Dodd-Frank Act was passed in July 2010, the CFTC's jurisdiction was limited to the $40 trillion futures market. The worst financial crash since 1929 and the worst economic crisis since the Great Depression prompted Congress to give the agency the additional responsibility for overseeing the previously unregulated $340 trillion swaps market—a market **over 8 times the size** of the futures market. As is widely known, this was necessary because the global financial crisis of 2008 was largely incubated in and triggered by dark, unregulated derivatives markets. The Dodd-Frank Act therefore amended the Commodity Exchange Act to require the CFTC to regulate those markets and require transparency and prudent risk management so that such a calamity would never happen again to the American people.

As I stated in my testimony, given how historic these changes are, the Committee should consider renaming the CFTC as the "Commodities Futures and Swaps Trading Commission" ("CFSTC") so that its name more accurately reflects the breadth and depth of its jurisdiction and mission. After all, its jurisdiction has increased enormously and has been extended to entirely new markets and products.

The CFTC has done an outstanding job in transforming the Dodd-Frank law into a derivatives market reality (even though we have often not agreed with particular provisions of certain rules). History will look back and laud its singular accomplishments. The CFTC is to be commended for this. However, it has been a struggle and, too often, needlessly so, mostly due to inadequate resources, which have deprived the agency of enough personnel and technology to do the job the law requires of it. Without a greatly increased budget and stable funding source, the CFTC will simply not be able to continue to implement the law, oversee these vital markets, ensure financial reform is a durable reality, and protect the American people from another derivatives-fueled crash.

At the same time, the CFTC provides crucial services to the marketplace, including issuing guidance, processing registrations, disseminating data, and protecting customers and market participants from abusive practices. These are all tasks that must be performed on time and to a high standard if they are to be useful to the market and market participants. Fully funding the CFTC is a small price to pay to ensure it gets its job done in a timely and thorough fashion.

The CFTC is Woefully Underfunded

From 1999 to 2007, the CFTC staff decreased from 567 full-time equivalents ("FTEs") to just 437. Currently, the CFTC has 690 FTEs which is less than 10% more than at the peak in the 1990s.[8] Comparably, the volume of futures trading in the United States from 2000 to 2013 has exploded from 491 million contracts per year to over 7 billion contracts per year, an increase of more than 1300%.[9] At the time of writing, the CFTC has just 162 FTEs in enforcement, (with a pending request for an increase to 213 FTEs for 2014).[10] This low number persists in spite of the fact that the Dodd-Frank reforms triggered by the financial crisis mean that the CFTC now has to police more registrants than ever before: 62,958 as of September 2012.[11] If the new rules and regulations are not properly enforced, financial reform will exist only in form, and not in substance.

Similarly, the Market Oversight division, responsible for monitoring the entire swaps and futures markets in real time, has just 119 FTEs.[12] The CFTC has requested sufficient funding to raise this number to 177 – still a low number, but one that stands a better chance of identifying emerging issues before they escalate. This is essential to the regulatory function, and could save investors and taxpayers large sums of money by preventing problems from arising in the first place rather than simply punishing wrongdoers after the fact.

Yet even with new surveillance personnel, 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" debacle[13] would currently go undetected, since "none of our computer programs load [Swap Data Repository] data without crashing."[14] According to Commissioner O'Malia, the current CFTC budget allows for only about $12 million for actual technology investment.[15] To put this in perspective,

---

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

9 Will Acworth, *Volume Climbs 11.4 percent to 25 Billion Contracts Worldwide*, FUTURES INDUSTRY, Mar. 2012, *available at* http://www.futuresindustry.org/files/css/magazineArticles/article-1383.pdf.

10 CFTC PRESIDENT'S BUDGET AND PERFORMANCE PLAN, FISCAL YEAR 2014, PREPARED FOR THE COMMITTEE ON APPROPRIATIONS, at 8 (Apr. 2013) *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2014.pdf.

11 *Id.* at 97.

12 http://www.cftc.gov/reports/presbudget/2014/2014presidentsbudget020102.html.

13 U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, JPMORGAN CHASE WHALE TRADES: A CASE HISTORY OF DERIVATIVES RISKS AND ABUSES (Mar. 15, 2013) ("PSI Report"), *available at* http://www.hsgac.senate.gov/download/report-jpmorgan-chase-whale-trades-a-case-history-of-derivatives-risks-and-abuses-march-15-2013.

14 Silla Brush, *Dodd-Frank Swap Data Fails to Catch JPMorgan Whale, O'Malia Says*, BLOOMBERG, Mar. 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.

15 Testimony of CFTC Commissioner Scott D. O'Malia Before the U.S. House Committee on Appropriations, Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies,

that is about as much as what just a dozen or so large high frequency traders might pay for a year's worth of colocation fees alone—to say nothing of the rest of their technology budget and that of the other entities regulated by the CFTC.[16].[17]

Sending the CFTC out to regulate and police these markets without adequate funding is setting them up to fail. Markets are adapting to the new rules of the road, and the regulators must be equipped with the technology and staff that they need to keep up.

And, again, we are talking about a modest amount of money. By way of comparison, the CFTC's entire budget for 2012, totaling $206 million, was less than half the $574 million paid in compensation in 2007 to the top executives at the nine banks who received the first round of TARP funds.[18] The President's pending budget request of $315 million for FY2014 is barely one fifth of the sum that "disappeared" during the MF Global fiasco, and only slightly more than what was misappropriated from customers in the fraudulent Peregrine Financial scheme that was discovered last year.[19] In light of the importance of its vastly expanded responsibilities, the CFTC's funding requests are reasonable, necessary, urgent, and for the benefit of the markets and all market participants.

User Fees are Assessed by Virtually All Federal Financial Agencies

A logical way to approach CFTC funding is through a deficit-neutral user fee model. User fees are revenues collected by a governmental agency for goods and services provided to the public. Since they are used to pay for the cost of providing those goods and services, they are considered "offsetting receipts" for accounting purposes. Thus, user fees ensure the public receives the protections necessary for the efficient functioning of markets, while also ensuring that those market participants who receive the greatest benefit from well-functioning markets pay a fair share of their costs. An added benefit of the deficit-neutral user fee model is that congressional appropriators maintain control over the level of agency funding – it is only the means of funding that is modified.

The federal government has historically employed user fees as a source of revenue for many years. In fiscal year 2012 alone, OMB reports about $8.6 billion dollars in user

---

Washington, DC (Apr. 12, 2013), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-23.

[16] Assuming three servers at the CME colocation facility (DC3), an HFT would pay approximately $11,000 per month in hosting, connectivity, and access fees (according to the CME price list). That works out to $132,000 per year just for one exchange, and most HFTs operate across a number of exchanges. For the largest such traders, therefore, an estimate of $1 million per year in colocation fees is not unreasonable.

[17] Assuming three servers at the CME colocation facility (DC3), an HFT would pay approximately $11,000 per month in hosting, connectivity, and access fees (according to the CME price list). That works out to $132,000 per year just for one exchange, and most HFTs operate across a number of exchanges. For the largest such traders, therefore, an estimate of $1 million per year in colocation fees is not unreasonable.

[18] *Big bank execs: What they take home*, CNN MONEY, http://money.cnn.com/news/specials/storysupplement/ceopay/.

[19] http://money.cnn.com/2012/04/24/news/companies/mf-global/index.htm and http://www.cftc.gov/PressRoom/PressReleases/pr6300-12

fees were collected by federal agencies. These fees are included in the Federal Budget, and congressional appropriators set the amounts that can be collected and utilized to offset the costs of the goods and services. For budgetary purposes the revenue and expenditure offset, so there is no real use of taxpayer monies. But the amounts collected and spent are recorded in Federal Budget documents.

With the exception of the CFTC, virtually every federal financial agency raises revenue through some sort of fee. For example, the OCC assesses a semi-annual fee on national banks and federal savings associations. The assessment is based on a financial institution's total assets and other information as reported in the call and thrift financial reports. The funds are used primarily to cover the cost of examinations. The FDIC and the Federal Reserve Board also have access to user fees, as does the SEC.

The federal financial regulator most closely mission-related to the CFTC is the SEC. The amount of money the SEC can collect to offset expenditures is set by the Congress each year for the next fiscal year. The SEC then charges securities transaction fees it will collect to equal the amount set by the appropriators.

In addition, the SEC is authorized to maintain a Reserve Fund of up to $100 million to pay for SEC expenses. This fund is not subject to congressional appropriations and is funded from filing fees the SEC collects. The agency can deposit up to $50 million per fiscal year but the funds in the Reserve Fund cannot exceed $100 million. Any excess filing fees are deposited in the Treasury General Fund and cannot be used to fund SEC operations.

And it is not just financial regulators who are authorized to assess user fees. For example, in a House-passed appropriation bill for FY 2014, the Federal Communication Commission ("FCC") is authorized and has been appropriated $320 million to fund the Commission's activities. The law also provides the FCC with the authority to assess and collect funds pursuant to Section 9 of Title 1 of the Communications Act of 1934, resulting in a final fiscal year appropriation of $0. Specific restrictions say that the agency can only spend $320 million. If excess fees are collected, they are sent the Treasury general fund and cannot be carried over to the next fiscal year.

Some agencies are authorized to offset only a portion of the revenue and expenditures. For example, fees to enter national parks can be used to offset the costs of maintaining the parks but are not intended to cover the entire amount of the activity. Another example is in a House-passed appropriation bill for fiscal year 2014, the Federal Trade Commission has $295 million appropriated for the agency. Of this amount, they may collect up to $103.3 million in fees for the premerger notification filing required by the Hart-Scott-Rodino Antitrust Improvement Act of 1976.

Thus, there is ample, long-standing precedent and ongoing practice for the CFTC to be funded, in whole or in part, by a small fee.

The Fees Required to Fund the CFTC Would Be Minimal and Would Not Harm Liquidity

DTCC data indicates roughly $72 trillion notional in annual swaps trading under the CFTC's jurisdiction.[20] Dividing this by the CFTC's $315 million budget request for 2014 and then dividing it by two (to account for the two counterparties to each trade) would only require a $2.19 fee per $1 million of notional value of swaps or just 0.0002%.

This CFTC funding fee in the swaps markets could be reduced if such a fee were also imposed on transactions in the futures market. The futures market, though smaller in outstanding notional size than the swaps market, turns over much more quickly. BIS data indicates that total notional trading in futures and options may therefore outnumber swaps by multiples.[21] Nevertheless, opponents of a user fee on futures rightly point out that futures were not implicated in the financial crisis, unlike swaps. Therefore, despite the fact that notional trading of futures exceeds that of swaps, we assume here a 50-50 split for the fee base between futures and swaps. This would reduce the $2.19 per $1 million of notional value figure to $1.08 per $1 million of notional value for swaps, which we round down to $1. At this level, the fee would add just $58 to the $1,000 cost of a typical interest rate swap transaction.

For futures, BIS data indicates that approximately $814 trillion of exchange traded options and futures change hands annually in North America. Even assuming a quarter of this occurs outside of the United States or otherwise outside of the CFTC's jurisdiction, that still leaves a $600 trillion fee base. This would require just 28¢ per million dollars of notional futures and options to generate the 50% funding share attributed to futures. At this level, just 10¢ would be added to the $10 transaction cost associated with hedging 500 acres worth of corn, a truly *de minimis* amount.[22]

The fees could be even smaller than this minimal level. For example, funding just 50% of the CFTC's budget with fees would require just 50¢ per $1 million of notional value traded on swaps, and 14¢ per $1 million of notional value traded on futures and options. This would amount to a $29 fee on a typical interest rate swap, and just 5¢ on a *bona fide* hedge of a farmer's entire corn crop.

Given its small size, such a fee would therefore have no noticeable impact on liquidity. Decisions to hedge or not are based on calculations of tens of thousands of dollars at the very least and more often hundreds of thousands if not millions. It is inconceivable that a fee ranging from a few cents to a few dollars would have any influence whatever on the economics of these decisions.

---

20 This total was calculated by averaging the total notional amount traded on a random sample of days in July and August 2013 (the only robust data currently available) and then multiplying by 252 annual trading days to obtain an estimate of total annual notional value traded. Raw data taken from https://rtdata.dtcc.com/gtr/inquiry.do.

21 BIS, Table 23A: Derivative financial instruments traded on organised exchanges, http://www.bis.org/statistics/r_qa1306_hanx23a.pdf.

22 *See* notes 1-4, *supra*.

Importantly, academic literature supports this observation. For example, recent research from the University of Massachusetts found that developed financial markets tend to tolerate transaction fees of up to 50 basis points with little or no impact on liquidity.[23] The proposed CFTC user fee would be just a hundredth of a basis point. Thus, the available evidence supports common sense and reasonable business decisions in suggesting that there would be no impact on liquidity from such a fee.

Conclusion

The CFTC can be fully self-funded by a *de minimis* user fee on swaps, and an even smaller user fee on futures and options. We hope you find this analysis useful as you continue to frame policy in this arena.

---

23 Robert Pollin & James Heintz, *Transaction Costs, Trading Elasticities and the Revenue Potential of Financial Transaction Taxes for the United States*, Political Econ. Research Inst., Univ. of Mass., Dec. 2011, *available at* http://www.peri.umass.edu/fileadmin/pdf/research_brief/PERI_FTT_Research_Brief.pdf.

Senate Committee on Agriculture, Nutrition & Forestry
Reauthorization of the Commodity Futures Trading Commission
Questions for the Record
July 17, 2013
Mr. Walt Lukken

Chairwoman Debbie Stabenow

1.) Are futures/swaps/options customers put at a disadvantage when a joint Broker Dealer/FCM bankruptcy is administered under SIPA? If it is a problem, does this Committee need to act to correct the problem?

Whether or not the bankruptcy is administered under SIPA, the customer property of futures/swaps/options customers continues to be protected under the bankruptcy code. SIPA specifically provides that, in the event a debtor broker-dealer is also a commodity broker, the SIPC trustee shall have the same duties as a trustee appointed under Chapter 7, subchapter IV of the Bankruptcy Code. However, the bankruptcy proceedings that ensued as a result of the M.F. Global Inc. failure displayed process concerns that may need to be addressed outside of the Commodity Exchange Act. For example, some have suggested that customers should have their own representative under SIPA in the form of a "customer committee", similar to the "creditor committee" that was established under the Chapter 11 proceedings for MF Global Holdings. NOTE: Chapter 11 proceedings have a creditors committee, since the presumption is that the company will be reorganized and continue to operate. Therefore, creditors should have a voice in whether or not the company is allowed to continue and under what circumstances. Chapter 7 proceedings, which result in liquidation of the company, do not have creditor committees.

2.) Some have suggested splitting joint BD/FCMs into two separate legal entities in order to remove risks to commodity customers, arguing that any costs are worth the benefits. Can you comment on this idea?

Many modern day FCMs are dually registered as Broker Dealers. The existence of flexible, and often complex, corporate organization is available to virtually every industry in the U.S. such that businesses - manufacturing, agricultural, financial services - have the flexibility to organize in such a way to best suit their individual situation. The development of joint BD/FCMs is no different and the value of such structures must be evaluated, not in the context of one failed entity, but more broadly as a tool available to ensure more efficient results for both the entity and its customers (often customers are trading in multiple markets and desire greater capital efficiencies).

Ranking Member Thad Cochran

1.) As the Committee with oversight jurisdiction of the CFTC, it is important for us to ensure market participants are protected and are able to hedge market risk in a cost efficient way. The "residual interest" issue is one of significant importance, and it is essential to ensure that this rule does not have unintended consequences. In your opinion, will recent CFTC actions with regard to residual interest adequately protect customers? If this rule had been in place prior to the

failures of M.F. Global or Peregrine Financial, is it possible that customers could have had more of their money tied-up with those FCMs when they failed, and thereby lost more money?
The CFTC has proposed a set of comprehensive regulations to further enhance customer protection and we support much of what they have suggested, including the codification of many of FIA's recommendations. However, among the many proposed changes to the regulations is a significant modification to the Commission's current interpretation of HOW customer margin obligations will be determined and WHEN an FCM must calculate each customer's segregation requirement and inject its own resources (commonly referred to as "residual interest") to address any potential shortfall in the customer's account. This proposal drastically re-interprets the long-standing application of the statute, even though the Commodity Exchange Act has not changed in this area since 1936. It is estimated that this re-interpretation would require FCMs to contribute significantly in excess of $100 billion into customer funds accounts beyond the sum required to meet initial margin requirements. This would result in significant funding issues for all FCMs, especially small and medium sized firms. Many of the commodity customers serviced by these firms have expressed strong concern, as they recognize that in order to meet these funding challenges firms may find it necessary to have customers pre-fund their margin. Under the worst scenario, the requirement might cause consolidation amount small and mid-sized FCMs. FIA has always supported customer choice and we believe the industry is stronger with more, not fewer, intermediaries carrying customer business.
It is possible that customers would have been posting more money with MF Global Inc and Peregrine Financial had this rule been in place during their operation.

2.) Many stakeholders have suggested that Congress should consider ways to strengthen protection of customers in the wake of the dramatic MF Global and Peregrine Financial failures. Some of the proposals that have been brought to our attention involve clarifications or changes to the Bankruptcy Code. In your opinion, should Congress consider changes to the Bankruptcy Code in order to better protect customers? If so, please briefly summarize proposed changes to the Bankruptcy Code that you think are most important and explain why they are important.
Over the past several months, the FIA has sought to coordinate various groups of stakeholders to determine if there are specific areas where the industry as a whole can reach consensus on any necessary changes to the bankruptcy code. Those discussions are ongoing and we will be happy to report any such suggestions to the various interested Congressional Committees once further developed.

3.) The CFTC has proposed and in some cases implemented many new rules in the last two years. However, in many instances, the CFTC rules have been accompanied by 11th hour "no-action letter relief" that provides market participants relief from the very rules that the CFTC just ratified. How have these incidences of last minute no action letters impacted the marketplace? How can this process be improved to better serve the marketplace?
Unfortunately, the new rules being written to facilitate the clearing of swaps are in some cases re-inventing the already proven clearing process that is familiar and tested for futures. Even those who have for many years operated within the existing futures clearing environment are being forced to seek temporary relief from the new regulation while they sort through compliance issues. Without such relief, market participants face the reality of either shutting down existing commercial activity or inadvertently being out of compliance as they seek to implement ambiguous and confusing regulations. While the CFTC has in many cased granted

temporary "no-action" relief to help mitigate this confusion, such relief is commonly provided at the very last minute (just before the rule takes effect) causing disruption for customers in both the futures and the swaps markets and causing tremendous resources to be wasted while market participants prepare for the worst and wait for last minute action. While the industry appreciates the opportunity to seek temporary relief in these circumstances, what necessitates this relief and the manner in which the relief is granted remain troubling.

Senator Heidi Heitkamp

1.) One idea that has been brought to my attention that may speed the return of customer funds when firms declare bankruptcy is a reform to the bankruptcy code. Current ambiguity in the code regarding the priority place of customer accounts versus creditors has resulted in delays in MF Global and Peregrine Financial Group. While the case for customer accounts being the first one out appears clear to me, it is not clear enough to the legal system to prevent earlier precedents from delaying the process. If the law were to require that contracts in CFTC regulated markets include subordination agreements that confirmed in writing that customer accounts were to be the first ones out in the event of bankruptcy – would that create any undesired consequences?

While "customer property" is protected under the bankruptcy code, what seems to be at issue with regard to the "earlier precedents" you mention is the authority of the CFTC to further define what constitutes "customer property". Due to the operational burdens and negative connotations associated with physically signing subordination agreements with all possible creditors, the concept you mention could very well result in FCMs finding it difficult to carry out daily business and operations with various affiliated and financing entities with which they engage. It seems a cleaner approach for Congress would be to simply clarify the CFTC's authority in this area.

Senate Committee on Agriculture, Nutrition & Forestry
Reauthorization of the Commodity Futures Trading Commission
Questions for the Record
July 17, 2013
Mr. Dan Roth

Chairwoman Debbie Stabenow

1.) At the hearing, you discussed how the NFA funds itself. Can you provide a detailed breakdown of this funding stream? Please include information on all assessments and fees that the NFA uses. Also, please provide information on how those funds are collected.

NFA Response
NFA's revenue budget for Fiscal 2014 (which runs July 1, 2013 thru June 30, 2014) is $84.5 million. Four categories of revenue comprise 98% of NFA's total revenue.

	Revenue	As a % of Total Revenue	Cumulative % of Total Revenue
FCM Assessment Fee	$36.2	43%	43%
Membership Dues	$36.2	43%	86%
Market Regulation Outsourcing Fees	$8.7	10%	96%
Registration Fees	$1.8	2%	98%
Other	$1.6	2%	100%
Total Revenue	$84.5		

FCM Assessment Fee - Pursuant to NFA Bylaw 1301, NFA imposes an assessment fee of $.04 on a round-turn basis for each commodity futures contract, and $.02 per side for each option contract, traded on a contract market. NFA's FCM assessment fee applies to public transaction volume, which is approximately 25% of all U.S. contract market volume.

Membership Dues – NFA charges annual Membership dues to its various categories of Membership. With the exception of Forex Dealer Members (FDM) and Swap Dealers (SD) & Major Swap Participants (MSP), membership dues are invoiced annually and are due in full on the Members' designated annual renewal date. Annual dues for FDMs and SDs/MSPs are invoiced quarterly.

Market Regulation – NFA contracts out regulatory services to designated contract markets (DCMs) and Swap Execution Facilities (SEFs). These clients are invoiced monthly for NFA's services.

Registration Fees – NFA charges various registration fees to both firms and individuals to help defray some of the costs associated with administering the registration process. Firms pay annual registration fees that are invoiced annually and are due in full on the registrants' designated annual renewal date. Registration fees for individuals (i.e., associated persons, firm principals, floor brokers, etc.) are paid once, at the time of registration.

2.) There was a call in some of the testimony for this hearing to increase the civil penalties that the CFTC is able to impose for violations of the CEA. Are current penalties out of date? If you do recommend updating them, what would you suggest those look like?

NFA Response
NFA did not cover this topic in its testimony. However, since the current level of the CFTC's civil monetary penalties was set several years ago, NFA supports a review of these amounts.

3.) You suggest reviewing whether it is a good idea for a joint Broker Dealer/FCM bankruptcy to be administered under SIPA. This is a fairly common criticism of the MF Global Bankruptcy. Who, or what, should determine where that bankruptcy occurs? Some market participants have suggested that splitting joint BD/FCMs into two separate legal entities will reduce risks to commodity customer property, arguing that the costs are worth the benefits. Can you comment on that idea?

NFA Response
With a few exceptions, all SEC registered broker-dealers (BDs) are required to be members of the Securities Investors Protection Corporation (SIPC), which was created under the Securities Investor Protection Act of 1970 (SIPA). When a BD fails, SIPC generally steps in and the BD is liquidated pursuant to SIPA. In fact, no SIPC member may file for bankruptcy without the consent of SIPC. Although the Court appoints the trustee, SIPC has input regarding the trustee selected.

MF Global was dually registered as a securities BD and an FCM; however, MFG's business was overwhelmingly FCM related and it had very few securities customers. Additionally, MFG's securities customers did not suffer losses due to the firm's insolvency. Because MFG was a BD, MFG is being liquidated pursuant to SIPA, which is designed to meet the needs of securities customers. Staff believes that CFTC Reauthorization should explore the issue of whether it is appropriate that all insolvencies involving BD/FCMs be liquidated pursuant to SIPA.

Some alternatives that could be explored include whether the type of bankruptcy regime should be driven by the primary business of the dually registered entity or if the current regime remains in place whether the CFTC, along with SIPC, should have significant input regarding the Court's selection of the trustee. This latter alternative is designed to ensure that the interests of commodity futures customers be protected.

Many FCMs are also dually registered as securities BDs. NFA has significant concerns about prohibiting this dual structure, and thereby requiring broker-dealer/FCMs to be split into separate legal entities. There is little, if any, concrete evidence to support the argument that such a separation would materially reduce the risks to commodity futures customers, and this type of prohibition would, in fact, likely be detrimental to customers. If BD/FCMs are required to be separate legal entities, then the capital costs associated with separating these businesses and operating them separately will increase significantly likely resulting in fewer FCMs. Given the consolidation of FCMs that has already occurred over the last several years, fewer FCMs means less competition, which clearly does not benefit customers.

4.) CME expressed concerns about the CFTC's proposed changes to Rule 1.52 – a rule that governs how SROs monitor FCM compliance with financial and related reporting requirements. In CME's comment letter on this issue from February 2013, they state that the limited regulatory exams that they conduct of FCMs are "not designed, nor should they be, to identify material weaknesses in internal controls over financial reporting. That is the role of the external auditor." Do you share this concern? If the designated SRO, the frontline regulators, can't identify material weaknesses in internal controls, do we have a regulatory accountability gap

NFA Response
The annual certified financial audit of an FCM performed by a CPA each year and the regulatory examination performed by the FCM's DSRO are not intended to duplicate each other and have different purposes. NFA's examinations are primarily aimed at assessing the FCM's compliance with NFA and CFTC requirements. Unlike a CPA examination, NFA does not issue a report that expresses an opinion with respect to the FCM's financial statements or issue an Accountant's Report on Material Inadequacies. However, while the ultimate purposes of these examinations are different, NFA examinations do specifically test the existence and adequacy of an FCM's internal controls system, which should be designed to provide reasonable assurance that the FCM's books and records are current and accurate so that the FCM's financial reports are reliable. In fact, NFA recently adopted an Interpretive Notice, which is pending CFTC approval, providing FCMs with guidance on the minimum standards that should be a part of an FCM's internal controls system. NFA also recently made substantive changes to our examination modules to conduct additional testing on FCM internal controls and to identify any material weaknesses in an FCM's internal control systems.

Ranking Member Thad Cochran

1.) Many stakeholders have suggested that Congress should consider ways to strengthen protection of customers in the wake of the dramatic MF Global and Peregrine Financial failures. Some of the proposals that have been brought to our attention involve clarifications or changes to the Bankruptcy Code. In your opinion, should Congress consider changes to the Bankruptcy Code in order to better protect customers? If so, please briefly summarize proposed changes to the Bankruptcy Code that you think are most important and explain why they are important.

NFA Response
NFA believes that the CFTC Reauthorization process should be used to pursue legislative changes in order to provide greater clarity and protection to commodity futures customers in the event of an FCM bankruptcy. One of the most important changes involves the definition of "customer property" with respect to an FCM bankruptcy.

Section 20 of the Commodity Exchange Act provides the CFTC with the authority to determine what property should be included in the definition of "customer property" with respect to an FCM bankruptcy. Pursuant to this authority, the CFTC adopted CFTC Regulation 190.08 over twenty years ago to provide that "customer property" includes the bankrupt FCM's cash, securities, or other estate property in instances where there is insufficient identifiable customer property to pay customers in full. The purpose of this Regulation is to ensure that until the customers of a bankrupt FCM have been paid in full, the FCM's general estate assets become "customer property" and the customers receive first priority in the distribution of those assets.

The validity of Regulation 190.08 was questioned in 2000 when, with respect to the Griffin Trading Company bankruptcy, the United States Bankruptcy Court for the Northern District of Illinois determined that the CFTC exceeded its statutory authority in promulgating Regulation 190.08 and denied the Bankruptcy Trustee's motion to use Griffin Trading Company's estate assets to pay customer claims that could not be paid in full with available customer assets. Although the Bankruptcy Court's order was later vacated due to a settlement agreement between the parties, the Court's order has cast a cloud over Regulation 190.08's validity.

In light of the Griffin Trading Company case, NFA believes that the issue of customer priority and what constitutes "customer property" is an extremely important issue that should be clarified in CFTC Reauthorization. NFA supports legislative changes to clarify that "customer property" includes an FCM's general estate assets so that in instances where customer assets are insufficient alone to satisfy customer claims then customers should receive first priority to the FCM's general estate assets until customer claims are paid in full.

<u>Senator Kirsten Gillibrand</u>

In the wake of the MF Global collapse, the Trustee's report stated that 78 percent of claims were below $100,000. Additionally, the Trustee's report found that, unlike those investments in securities- which are covered by the SIPC insurance fund - commodities customers were left without any insurance to redress losses associated with the illegal transfers within MF Global.

The National Futures Association (NFA) conducted a study of the cost and benefits associated with providing a commodities insurance fund in 1986. But, as you know, there have been many changes to the commodities market since then.

1.) I know the Futures Industry Association (FIA) is looking into this issue of a commodities insurance fund. But from your perspective as head of the NFA, what is your timeframe in reexamine the issue of creating an insurance fund for commodities accounts, like we have on the securities side?

<u>NFA Response</u>
NFA has joined with Futures Industry Association, CME Group, and the Institute for Financial Markets to commission a detailed analysis of various alternative approaches to customer account insurance. Armed with detailed customer account information from small, medium and large FCMs, the study will analyze and estimate the potential costs and assess the potential benefits of

various possible forms of a customer account insurance program. It is anticipated that the study will be completed in mid-September.

2.) How could a commodity insurance fund facilitate the distribution of customer assets to clients of a Futures Commission Merchant (FCM) following a FCM bankruptcy, and why couldn't we apply the user-funded SIPC model to commodities?

3.) Global financial institutions often have broker-dealers and FCMs, as part of their business models, trading in both commodities and securities, like MF Global. Would a single insurance fund that covers both commodities and securities be more efficient to administer and redress customer losses then separate funds?

NFA Response
Customer account insurance can take many forms. The sponsors of the customer account insurance study agreed to analyze the following models: (1) a direct insurance model (either voluntary or mandatory) whereby one or more primary insurance companies provides insurance directly to customers; (2) a risk retention group (RRG) or mutual insurance model whereby an insurance company agrees to provide insurance up-front to customers but is reinsured by an industry funded RRG or customer owned mutual insurance company; (3) a risk financing model that would provide FCM customers with access to funds in the event an FCM's failure results in a possible loss of customer assets with any remaining funds held in customer accounts being frozen; (4) Commissioner Chilton's proposed insurance scheme modeled after SIPC; and (5) the Commodity Customer Coalition's proposed model—a voluntary insurance program offered by an RRG that is owned by FCMs, IBs, CPOs, and CTAs. Once this study is completed, we should be better able to assess whether any of these models would work in the futures industry.

Senator Heidi Heitkamp

1.) In your testimony, you discuss the issue of insurance for segregated account customers. I understand that private sector approaches to this type of insurance product are currently being studied. I also understand that there are some concerns about the ability of a private entity to underwrite this insurance pool. Insurance gives customers confidence, which is among my most important priorities in any policy response to MF Global and Peregrine Financial considered under CEA Reauthorization. Can a private insurance pool for segregated customer accounts be realized that is not detrimental to liquidity and efficiency?

NFA Response
As we discuss the topic of customer account insurance, we should bear in mind three points. First, customer account insurance can take many forms. There are alternatives to the SIPC, government sponsored model. Private insurance solutions can take several forms in terms of who is covered and to what extent. Second, public confidence in the markets is critical, but it is a means to an end. The real goal is to ensure that futures markets are effective and efficient and a benefit to the economy. Markets must therefore be liquid and that requires public confidence. However, attempting to bolster public confidence through insurance programs that prove to be

cost prohibitive is self-defeating and would damage the liquidity we are trying to foster. Finally, this question is too important to be dismissed out of hand because various other forms of insurance might be too expensive.

In analyzing these various forms of insurance, we need data for Congress to make an informed decision. With this in mind, NFA has joined with the CME Group, Futures Industry Association and the Institute for Financial Markets to commission a detailed analysis of various alternative approaches to customer account insurance. Armed with detailed customer account information from small, medium and large FCMs, the study will analyze and estimate the potential costs and assess the potential benefits of various possible forms of a customer account insurance program.

2.) Can you share any thoughts on how this product could be derived?

NFA Response

The sponsors of the customer account insurance study agreed to analyze the following models: (1) a direct insurance model (either voluntary or mandatory) whereby one or more primary insurance companies provides insurance directly to customers; (2) a risk retention group (RRG) or mutual insurance model whereby an insurance company agrees to provide insurance up-front to customers but is reinsured by an industry funded RRG or customer owned mutual insurance company; (3) a risk financing model that would provide FCM customers with access to funds in the event an FCM's failure results in a possible loss of customer assets with any remaining funds held in customer accounts being frozen; (4) Commissioner Chilton's proposed insurance scheme modeled after SIPC; and (5) the Commodity Customer Coalition's proposed model—a voluntary insurance program offered by an RRG that is owned by FCMs, IBs, CPOs, and CTAs.

3.) Is there any role in CEA Reauthorization for advancing a private insurance product for customer accounts?

NFA Response

The customer account insurance study is looking at various models including mandatory and voluntary insurance. A voluntary insurance program would not need legislation. Legislative changes would need to be considered if it is determined that a mandatory insurance program would be prudent after considering the costs and impact on liquidity.

4.) The SIPC insurance model at the SEC covers customer accounts up to $500,000 from financial harm if a broker dealer fails. The size of the coverage provided by SIPC – $500,000 – would benefit the agricultural customers in my state of North Dakota and would have shielded them from harm from MF Global collapse. I recognize that there are major differences between the futures markets and the securities markets – most notably the difference in size – but I am interested in hearing your thoughts on whether or not a SIPC type model could work for a CFTC customer insurance fund. Can a SIPC type model be crafted that does not result in dramatically increased transactions costs from fees that will inevitably be passed on to customers?

NFA Response

When the customer account insurance study is completed, NFA and others will be in a much better position to measure the appropriate costs and benefits of these various insurance models.

In the meantime, NFA notes that there currently is a protection fund in place for certain commodity customers (i.e., ranchers and farmers). Specifically, in April 2012, CME established a $100,000,000 Family Farmer and Rancher Protection Fund. In the event of a future insolvency of a CME clearing member or market participant that causes customer losses, the fund will provide up to $25,000 to individual farmers and ranchers and $100,000 to agricultural co-ops who use CME markets to hedge their crops and livestock.

5.) Some have argued that the SIPC is not suited for the commodities markets because the insurance is too slow to pay out. In the event of a collapse, farmers need their funds back right away so they can stay liquid enough to meet their obligations. Could an insurance pool be crafted in way that results in a quick payout?

NFA Response
Question 2 above details the various customer account insurance models to be analyzed in the customer account insurance study. One of those models includes a risk financing model that would provide FCM customers with access to funds in the event an FCM's failure results in a possible loss of customer assets with any remaining funds held in customer accounts being frozen.

6.) What are some factors that can delay the transfer of customer funds out of failed companies and back into the customers' bank accounts?

NFA Response
Similar to MF Global and Peregrine matters, one factor that could delay the transfer of customer funds out of failed companies and back into the customers' bank accounts is very simply that there is no money left to return. In both MF Global and Peregrine, the firms fraudulently took money belonging to customers. Over the past 18 months, we have worked closely with the CFTC and other self-regulatory organizations (SROs) to adopt a number of initiatives to further safeguard customer funds. (See Attached)

One other factor that could delay the transfer of customer funds is the failure of the FCM to maintain adequate books and records with current and accurate data detailing the amount of funds owed to each customer. A critical component of NFA's FCM oversight program is to ensure that FCMs maintain current and accurate books and records.

O