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

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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.