United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510–6250

January 18, 2011

SUMITTED VIA: http://comments.cftc.gov

Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

RE: RIN 3038-AD19: Registration of Foreign Boards of Trade

Dear Mr. Stawick:

The purpose of this letter is to express support for the rules proposed to implement Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Closing the "London loophole" through these rules and establishing firm registration requirements for foreign boards of trade is central to effective market surveillance and reining in potential abusive trading practices that may lead to large and unpredictable price swings. The Commission should take strong measures to ensure that members of Foreign Boards of Trade (FBOT) or other market participants granted direct access to FBOTs cannot use foreign and U.S commodity markets to hide potential manipulative activity or excessive speculation from CFTC oversight. The proposed rules give the Commission the authority to prevent those abuses, but it will also need a robust supervision program of the FBOTs, as well surveillance and examination programs that include an integrated review of FBOT and U.S. trading activity.

BACKGROUND

In recent years, many Americans have experienced wild fluctuations in energy and food prices. The crude oil, natural gas, gasoline, heating oil, and agriculture markets have all seen large price swings, which can affect the prices of everything from transportation, to food, to manufacturing. These fluctuations cannot be explained by simple changes in supply and demand. Rather, they have been linked to excessive speculation in futures and other commodity markets. One of the loopholes that allowed for increased speculation in foreign exchanges is called the "London loophole."

The London loophole allows traders to avoid position limits that apply to trading on U.S. futures exchanges by directing their trades onto foreign exchanges like the ICE Futures Exchange in London. ICE set up trading of U.S. produced and used crude oil on a London exchange, outside of the CFTC's jurisdictional reach. In 2008, the Commission took important steps towards closing the loophole by requiring U.S. commodities traded on the London exchange to comply with position limits that are comparable to those in the United States, in order for the exchange to keep its trading terminals in the United States.

Congress directly addressed this issue in the Dodd-Frank Act. Title VII provides for registration of foreign boards of trade, and directs the Commission to adopt rules and regulations establishing registration procedures and requirements. To more fully ensure the Commission can obtain the information it needs to detect price manipulation and excessive speculation involving U.S. futures trades on foreign exchanges, Congress also provided the CFTC with clear legal authority to obtain trading data from foreign exchanges operating in the United States through direct trading terminals.[1]

The proposed rules contain enhanced provisions on registration eligibility and continuing obligations of FBOTs. The Subcommittee believes that several of these proposed provisions are key: (1) that trading data is to be provided in a timely manner to the Commission; (2) that position limits for linked contracts are adopted on FBOTs; and (3) that members of the FBOT or other participants submit to the jurisdiction of the Commission. These key provisions will ensure that the Commission is able to police FBOT trading in U.S. commodities to stop excessive speculation, price manipulation, and market disruptions.

SUBCOMMITTEE INVESTIGATION

For over five years, the Permanent Subcommittee on Investigations has been examining regulated and unregulated commodity markets that trade in U.S. commodities. In particular, we have examined role of excessive speculation in causing unwarranted changes in commodity prices that can push up prices at the expense of American consumers and businesses.

In 2006, for example, the Subcommittee released a report which found that billions of dollars in speculative trading on the crude oil market had pushed up futures prices in 2006, caused a corresponding increase in cash prices, and was responsible for an estimated $20 out of the then $70 cost for a barrel of oil.[2] A 2007 report showed how a single hedge fund named Amaranth made huge trades on the natural gas market, pushed up futures prices, and increased natural gas prices for consumers and American business.[3] In 2009, we held a hearing using the wheat market as a case history to examine how commodity index trading, in the aggregate, can cause excessive speculation and price distortions.[4] As part of those efforts, the Subcommittee

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[1] Dodd-Frank Act, § 738.

[2] 2006 Report, "The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat," S. Prt. 109-65 (June 27, 2006).

[3] 2007 Report, "Excessive Speculation in the Natural Gas Market," reprinted in S. Hrg. 110-235 (June 25 and July 9, 2007).

[4] 2009 Report, "Excessive Speculation in the Wheat Market," (June 24, 2009), available at http://hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_id=26f85374-c43a-4e2a-ac16-b64a40ca263a.

found that the London loophole allowed traders of U.S. commodities to avoid CFTC oversight and enforcement authority by trading on foreign exchanges.

FOREIGN BOARDS OF TRADE

Foreign boards of trade may currently provide direct access to their electronic trading and order matching systems from within the United States under a system of no-action letters. Under the Dodd-Frank Act, the Commission is required to establish a formal, standardized registration system for foreign boards of trade seeking to operate their trading terminals within the United States. This registration system will add statutory and regulatory weight to the conditions the CFTC has imposed under the no-action letter system in recent years.

Sharing Trading Data

Sharing trading data is vital for the Commission to detect price manipulation and excessive speculation involving U.S. futures traded on foreign exchanges. The Dodd-Frank Act mandates publication of some daily trading information.[5] The proposed rule includes the statutory provision, as well as a provision requiring the foreign board of trade to provide trade execution and audit trail data for the Commission's Trade Surveillance System on a trade-date plus one basis for all linked contracts.[6]

We support requiring FBOTs to provide this information to the Commission, and support the adoption of this provision. Having this data is crucial and must be included in the surveillance efforts of the CFTC and the self regulatory organizations. Otherwise, abusive trading occurring on the FBOTs impacting U.S. commodities markets will escape oversight and enforcement efforts.

Applying the Same Position Limits

The Dodd-Frank Act contains a provision requiring foreign boards of trade seeking to maintain trading terminals within the United States to adopt position limits on linked contracts that are comparable to the limits in the country in which the contract settles.[7] The proposed rule includes this provision requiring comparable position limits.[8] We believe position limits play a vital role in preventing excessive speculation, price manipulation, and market disruptions. Due to their importance, it is critical that the Commission require FBOTs to apply the same position limits to linked contracts that would apply in a U.S. exchange. To ensure compliance, the Commission will need to monitor the FBOT rules, compliance, and enforcement programs, and review the trading activity in U.S. commodities that is being effected across market venues.

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[5] Dodd-Frank Act, § 738(a).

[6] § 48.8(c)(1)(i); § 48.8(c)(2)(i).

[7] Dodd-Frank Act, § 738(a).

[8] § 48.8(c)(1)(i).

CFTC Authority to Police U.S.-Based Traders

The proposed role includes a provision stating that all members and participants not already registered with the Commission using direct access to the foreign board of trade's trading system will agree and submit to the jurisdiction of the Commission. The Commission also states that it "retains plenary authority to address manipulative or abusive trading practices that affect U.S. futures and cash markets and market users, and would use that enforcement authority when necessary and appropriate."[9] This clear authority will help ensure the Commission can police all traders trading in U.S. commodities, no matter what exchange they use, and can take action for misconduct no matter what exchange is involved.

This proposed rule takes a critical step forward toward ensuring the integrity of U.S. commodity markets. To ensure market integrity, however, the Commission will need to effectively police U.S. based trading in FBOTs and incorporate that trading into its regular surveillance and enforcement efforts. The Commission will further need to bring enforcement cases against individuals who attempt to avoid detection by trading in foreign markets in order to deter such activity.

The proposed rule appears designed to prevent cross market trading abuses and close the London loophole which allowed traders to evade U.S. oversight. It should result in strengthening of the Commission's enforcement program to ultimately provide for greater investor protection.

Thank you for the opportunity to comment on these proposed rules.

Sincerely,

Carl Levin

Carl Levin
Chairman
Permanent Subcommittee on Investigations

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[9] Registration of Foreign Boards of Trade; Proposed Rule, 75 Fed. Reg. 70982 (Nov. 19, 2010).