COMMODITY MARKETS OVERSIGHT COALITION

An Alliance of Derivatives End-Users & Reform Advocates

November 1, 2010

Delivered Via Email: dfarulemakings@cftc.gov

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
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Re: General Comments on Implementation of Title VII the Dodd-Frank Act

We appreciate the opportunity to submit these general comments for the consideration of the Commodity Futures Trading Commission (the "CFTC" or the "Commission") during its ongoing rulemakings with respect to the implementation and enforcement of regulatory initiatives under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act").[1]

Introduction

Formed in 2007, the Commodity Markets Oversight Coalition (the "CMOC") represents an array of interests, including commodity producers, processors, distributors, retailers, commercial and industrial end-users, and average American consumers. CMOC was established to promote government policy and regulation in the commodity trading markets – including the energy and agricultural markets – that preserve the interests of *bona fide* hedgers and consumers and the health of the broader economy. We seek stable and reliable commodity markets that perform a price discovery function reflective of tangible economic fundamentals, and that are free of manipulation, fraud, and excess volatility and speculation.

The last decade has shown that inadequate transparency, oversight and accountability in the derivatives markets contribute to excessive volatility and speculation. This leads to price uncertainty, unexpected and unwarranted price spikes, and diminished end-user confidence in these markets. Representatives of CMOC member groups have testified before the U.S. Congress and the Commission on these issues.[2]

The commodities futures and derivatives markets were established as price discovery and risk management tools for *bona-fide* hedgers of physical market exposures. While speculators play a vital role in keeping markets functional and liquid, excessive speculation causes markets to become unhinged from economic fundamentals. In 2007-2008, opaque derivatives trading and excessive speculation contributed to the largest commodities bubble in U.S. history.[3] The damage to the U.S. and global economies caused by this bubble and its bursting highlighted the need for significant reform and lead the Congress and the President to enactment the derivatives reforms in Title VII of the Dodd-Frank Act.[4]

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[1] Pub.L.111-203

[2] Additional information on the coalition, its member groups and advocacy efforts may be found at http://www.nefiactioncenter.com/commoditymarkets.php.

[3] We are willing to provide the Commission, upon request, with testimony, reports and studies proving that opaque trading and excessive speculation has played a major role in unwarranted commodity price bubbles.

[4] *Obama Announces Plan to Fully Close the Enron Loophole, Crack Down on Energy Speculation,* Press Release, Barack Obama Presidential Campaign, Chicago, IL (June 22, 2008) and U.S. Senate, Senator Blanche Lincoln

Recommendations for Implementation

Following the bursting of the 2008 commodities bubble, CMOC pressed Congress to pass financial reform legislation that would provide the Commission with adequate authority and resources to ensure that the derivatives markets would become transparent and functional, and to protect them from manipulation, fraud and excess speculation. We recognize the CFTC as the sole federal regulator with the institutional experience, qualifications and mandate to adequately regulate the non-securities-based derivatives markets, including previously unregulated over-the-counter markets and foreign boards of trade that conduct business in the United States.

We are pleased with the final Act and we are grateful the Commission is engaging in transparent and cooperative rulemakings to expedite its implementation. We commend Chairman Gensler and Commissioners Dunn, Chilton, Sommers and O'Malia and their staff for their commitment to this reform effort, their ambitious and comprehensive efforts with respect to implementation and enforcement of the Act, and their willingness to consider comments from regulated industry, consumers and the general public.

Vigorous implementation and enforcement of the regulatory initiatives under the Dodd-Frank Act is vital if the legislation to have its desired effects. While the Commission is up to the task, we also acknowledge that the process will not be without contention. The financial services industry has, in recent decades, viewed the commodities derivatives markets as an investment opportunity, and has many times sought exemptions and preferential treatment from the Congress and the Commission.

We write to provide the Commission and its staff with the following comments on several key areas requiring rulemakings as identified by the CFTC, as well as issues that may require additional examination and consideration. We stand ready to provide any additional thoughts or comments requested, or to answer any questions that they may have of CMOC or any of its affiliated member organizations.

Definitions

In connection with CFTC's request for comments on certain key definitions under Section 721 of the Dodd-Frank Act, CMOC would like to submit the following comments on the terms "major swap participant," "commercial risk," "captive finance affiliates" and "swap:"[5]

1. *Major Swap Participant*

   Regarding the definition of "major swap participant" under Section 721(a)(16) of the Act, it was the intent of Congress to require that only large market participants be captured under this definition (i.e., systemically significant market participants and market participants whose positions can materially affect the integrity of the market). For this reason, we are supportive of the exclusion for "positions held for hedging or mitigating *commercial risk*," subject to the significant concerns over CFTC's interpretation of the term "commercial risk" as discussed below.

Statement on Non-bank Financial Companies, H.R.4173, 111th Cong, 2nd Session, *Congressional Record* 156, Iss. 105, p.S5918 (July 15, 2010).

[5] *Advanced Notice of Proposed Rulemaking on Definitions Contained in Title VII for the Dodd-Frank Wall Street Reform and Consumer Protection Act*, Published by the Commodity Futures Trading Commission, 75 FR 51429 (Aug. 20, 2010).

2. *Commercial Risk*

The Commission has authority under the Act to define “commercial risk” under Section 721(b)(1). This definition is the cornerstone of the derivatives reform mandated by Congress, as it drives the scope of the parties that may be exempt from the Act’s procedures that are to be put in place to reign in excessive speculation. As such, the definition of “Commercial risk” should be narrowly tailored to apply only to those entities whose businesses expose them to risk from physical commodity price fluctuations. “Commercial risk” should not include risk that is purely financial in nature, including balance sheet risk. We reject the assertion that “commercial risk” is essentially any business-related risk other than risk associated with the movement of physical commodity prices. Such an interpretation would imply that the risk management needs of purely financial market participants are “commercial” in nature. Adoption of such an indiscriminately broad definition would eviscerate some of the most important requirements of the Act, compromise the integrity of these markets and it would be in conflict with Congressional intent. While financial firms have and will urge as broad a definition as possible, we urge the Commission not to exempt hedge funds and other financial entities from the Act’s provision by defining “commercial risk” to include purely financial risk.

3. *Captive Finance Affiliates*

The major swap participant definition also includes an exception for captive finance affiliates and we have an appreciation for Congressional intent with respect to the inclusion of this exception. While the CFTC has no choice but to preserve this exception as required by the Act, we similarly encourage the Commission not to allow the exception to be abused or too broadly interpreted.

4. *Swap*

And finally, care should be taken when interpreting the definition of “swap” and its relative exclusions under Section 721(a)(21). The definition excludes forward delivery contracts (and options on such contracts) for commodities that are intended to be “physically settled.” This interpretation could potentially be abused and the Commission should take necessary steps to prohibit the exclusion from being used to evade the requirements of the Act, including that any exemption for forward delivery contracts and options should be limited to *bona fide* commercial end-users.

Governance & Possible Limits on Ownership & Control

During the debate on the financial reform legislation on the floor of the U.S. House of Representatives in December of 2009, we endorsed an amendment offered by Representative Stephen F. Lynch of Massachusetts that would have prohibited swap dealers from controlling more than 20 percent of a clearinghouse or swap exchange facility. The amendment was ultimately approved.[6] However, it was not ultimately included in the final bill that was signed into law.

Rather, Section 726(a) of the final version requires the CFTC to “adopt rules which may include numerical limits on the control of, or the voting rights with respect to, any derivatives clearing organization that clears swaps, or swap execution facility or board of trade designated as a contract market that posts swaps or makes swaps available for trading” by large banks, non-bank financial companies, swap dealers, major swap participants, or associated persons of a swap dealers or major swap participants. While it is not identical to Rep. Lynch’s amendment, it is reflective of the goals of his amendment and addresses the need to prevent consolidated ownership and control.

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[6] The “Lynch Amendment,” H.Amdt.521 to H.R. 4173 was passed 228-202, Roll Call Vote No. 955, (Dec. 10, 2009).

We understand that the Commission has begun consideration of a proposed rule to carry out its responsibilities under the Act regarding mitigation of conflicts of interest in ownership of Derivatives Clearing Organizations, Designated Contract Markets and Swap Execution Facilities.[7] One of the models of governance under the request proposes that a clearing facility may choose to limit the ownership voting interest of any participant, such as a swap dealer or bank, to no more than 5 percent of the total, but the proposal lacks any aggregate or collective ownership limit on such entities.

Without an aggregate cap on ownership, 11 dealer banks could band together, each take a 5 percent ownership as per the suggested cap, and collectively own a controlling stake in a clearinghouse. Such proposals run contrary to Congressional intent in providing the Commission with this new authority, as stated in an October 18, 2010 letter to the Commission from Rep. Lynch regarding the nature of the new authority granted the Commission under Sections 726 and 765 of the final Act:

> Congressional intent is clearly on the side of open and meaningful competition. That intent would be erased by providing a loophole that basically allows a mere 11 dealers to dominate the clearinghouse, control a majority of its members, and dictate decisions of the organization by banding together with shared ownership under 5%. The largest dealers in this marketplace already have control of incumbent clearinghouses and could easily adapt to this structure, resulting in business as usual. I urge the SEC and CFTC to stay true to Congress' clear intent to stop any entity or group of entities from dominating the clearinghouses, swap execution facilities or exchanges that are so vital for successful implementation of the Dodd-Frank legislation. We need deep, competitive markets where risks are dispersed and transparency reigns supreme.

According to a statement by the Office of the Comptroller of the Currency, the five largest banks currently control 96 percent of derivatives activity.[8] Banks already control many clearinghouses and using a 5 percent rule with no aggregate class-based cap, they could simply band together and take a controlling ownership by making minor adjustments to their current ownership stakes.

The CFTC must establish both a meaningful limit on individual ownership and a limit on *collective* ownership if the proposed rule is to have the intended effect of limiting conflict of interest, assuring transparency and open competition, and preventing clearinghouses and exchanges from catering to the interests of a few large participants in the financial community.

End-User Exception

During consideration of the Dodd-Frank Act in Congress, CMOC supported efforts to include a narrow exemption from clearing requirements for legitimate commercial (i.e., non-financial) entities that use derivatives to manage risks associated with their businesses. The financial services industry including hedge funds, investment banks and insurance companies sought inclusion in this exemption. They argued that they were also *bona-fide* hedgers. We informed Congress that while these financial entities may have a legitimate interest in hedging credit, business and balance sheet risks, they are not producers, distributors or end-users of physical commodities, and so should not be included in any end-user exemption.

These financial entities' so-called "hedging" activities have dramatically increased volatility and uncertainty in commodity prices and have resulted in dramatic price swings that are injurious to

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[7] *Notice of Proposed Rulemaking on Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of conflicts of Interest*, Published by the Commodity Futures Trading Commission, 75 FR 63732 (Oct. 18, 2010).

[8] *OCC Quarterly Report on Bank Trading and Derivatives Activities: Second Quarter 2010* (Sept. 27, 2010).

traditional commodity end-users. For these reasons, financial entities should not be exempt from mandatory clearing requirements under the Act. The end-user exception should remain narrowly tailored to those businesses that produce, refine, process, market or consume an underlying commodity and counter-parties buying or selling a position to an end-user so long as that position is established to satisfy the demand of a *bona-fide* end-user. The definition of "commercial risk" as discussed above is critically important to insuring that the end-user exception is not interpreted so broadly as to undermine the intent of the Act.[9] Transactions by counter-parties that are not with *bona-fide* end-users should not fall within the end-user exception as found in the final version of the Act.

New Registration Requirements for Foreign Boards of Trade

CMOC strongly favors the imposition of transparency requirements and CFTC oversight of Foreign Boards of Trade (or "FBOTs") that provide direct U.S. access to their trading platforms. Despite the trading of derivatives linked to physical commodities for ultimate delivery and consumption within the United States, such trading environments are currently not subject to CFTC jurisdiction under letters of *no action* or other exceptive protocols. Off-shore oversight and regulation is non-existent due to either the absence of a futures regulator in the FBOT's home country, or at least the absence of a comparable regulatory regime to that which exists here in the United States.

Therefore, we support the requirements under Section 738 of the Dodd-Frank Act providing the Commission with additional authority to require that such FBOTs register with the CFTC and make their trading data available, as well as requiring that they adopt position limits and implement prohibitions on manipulation and excessive speculation. In promulgating rules relative to the requirement that FBOTs impose position limits, we encourage the Commission to require that the entity impose limits that are at least equal to or lower than the limits to be imposed here in the United States under Section 737 of the Dodd-Frank Act. We also urge the CFTC to extend the same limits on ownership and control (as discussed above) to FBOTs seeking U.S. access under the new rules.

Section 738(a)(4) of the Act exempts existing FBOTs from these new requirements until 180 days after enactment. At that time, we urge the CFTC to conduct a thorough review FBOTs that currently retain letters of *no action* and expeditiously enforce the requirements of the Act on said entities.

Anti-Manipulation & Disruptive Trading Practices

The final version of the Dodd-Frank Act includes strong enforcement authority, as well as prohibitions on "insider trading" based on nonpublic information, prohibitions on manipulation and trading on false information, and new authority to identify swaps that are "abusive" by virtue of being potentially detrimental to either the stability of the market or its participants.[10] We strongly support these measures and urge the CFTC to be thorough in its interpretation and enforcement of these new authorities.

We also commend the Commission for its recent request for information from the public regarding computerized/algorithm-based trading, including high-frequency trading and colocation; their application and use in the commodities markets; and whether or not they have a disruptive affect on market stability or function. Further, the CFTC should examine whether or not such tools and trading practices could open the door to fraud and manipulation and consider whether or not they are appropriate for these markets. Either CMOC and/or its individual member groups will be commenting on these matters separately.

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[9] Dodd-Frank Act, §723(a) includes in the end-user exception any entity that "is using swaps to hedge or mitigate commercial risk."

[10] *Ibid.*, §§741, 746, 753, and 714, respectively.

Position Limits, Aggregate Position Limits & the *Bona Fide* Hedging Definition
Last year, the Commission acknowledged its responsibility under existing law to prevent excessive speculation as an undue and unnecessary burden on interstate commerce through the imposition of speculative position limits, and so conducted several hearings and published proposed rules that would have placed limits on energy and metals contracts on regulated exchanges. CMOC members commended the CFTC for its efforts, and several CMOC member groups testified, submitted statements for the record and comments on the proposed rule.

The 111th Congress, in the Dodd-Frank Act, acknowledges the potential harm of excessive speculation and has reaffirmed the importance of position limits by providing the Commission with expanded authority to impose such limits on currently unregulated markets, including electronic boards of trade, foreign boards of trade (see above) and the over-the-counter markets. It also provides authority to establish position limits in the aggregate across all markets.[11]

We commend the Commission and the Congress for acknowledging the need for position limits; however, we have lingering concerns. The formulae proposed by the CFTC must result in position limits that are low enough to have a meaningful effect on excessive speculation, and thereby bring renewed stability and confidence to the commodity markets. The statute *clearly states* that the Commission *shall* set position limits to diminish, eliminate or prevent "excessive speculation."[12] We urge the Commission to consider carefully how they will ensure position limits deal adequately with excessive speculation. It is not enough to deal just with manipulation; excessive speculation will require a stricter approach.

Also, the Act requires the CFTC to complete the formulation and imposition of position limits and begin enforcement of the limits within 180 days from enactment for exempt commodities (including energy commodities) and 270 days from enactment for agricultural commodities as required by the Act, not simply the promulgation of formulae for establishing limits that can be then imposed at some later date, as has been suggested.[13]

Further, in promulgating new rules under this Section, we urge the CFTC to consider the increasing role of Exchange Traded Funds in the commodity markets. Their passive approach to commodity trading treats finite commodities as an asset class rather than as vital resources to American industries, businesses and consumers. They do not behave like traditional speculators and therefore should not be treated as such. We propose that the Commission establish separate and more aggressive limits on the positions of Exchange Traded Funds and Notes, including index funds.

We also have concerns regarding the *bona fide* hedging exemption that are similar to our concerns regarding the definition of "commercial risk" and the end-user exemption. Too broad of a definition would allow a continued watering down of the hedging exemption and provide additional incentives for financial speculators to enter the market in the guise of legitimate hedgers, thereby evading position limits and other requirements.

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[11] *Ibid.*, §737.
[12] *Ibid.*, §737(a)(4)
[13] That the CFTC might simply finalize formulae for determining position limits by the deadlines listed in the Act, rather than implement formulae and requiring that limits be imposed by said deadlines, was suggested by Chairman Gary Gensler at the Commission's Second Open Meeting on Proposed Rules under the Dodd Frank Act on Tuesday, October 19, 2010.

Energy & Environmental Markets Advisory Committee
The Dodd-Frank Act makes permanent the "Energy and Environmental Markets Advisory Committee" (the "EEMAC") under Section 751. The Act not only makes the committee permanent, but also requires it to serve "as a vehicle for discussion and communication on matters of concern to exchanges, firms, end-users, and regulators regarding energy and environmental markets." The EEMAC was founded under then-Acting Chairman Walt Lukken in February of 2008 and currently chaired by Commissioner Bart Chilton. For several energy and consumer groups in CMOC, the EEMAC has been a valuable forum for discussion of the Commission's oversight role in the energy and environmental markets and has provided an opportunity to address thoughts and concerns directly to Commissioners and their staff.

The Act requires that the Committee meet no less than twice per year. The Commission should schedule those meetings well in advance and on a seasonal basis, once at the beginning of peak driving season (in May of each year) and the second at the beginning of peak heating season (in October of each year). We also feel that the Commission should call for unscheduled meetings of the advisory committee in the event of market emergencies, such as unanticipated/unwarranted energy price spikes, supply disruptions and dislocations, or when market participants experience periods of excess volatility or speculation.

The Commission is required to appoint members to the committee that are representative of "a wide diversity of opinion and who represent a broad spectrum of interests, including hedgers and consumers." While the Act requires that the committee have nine members, it does not require it to have "no more than" nine members, and therefore the Commission should interpret "nine" as a minimum number. Otherwise the Commission will be hard pressed to create a diverse committee membership as required under the Act given the limited number of seats.

Studies Required under Dodd-Frank
The Dodd-Frank Act requires the following studies and reports to Congress on a variety of issues of interest to CMOC and its member groups, and we stand ready to assist the Commission with information relevant to its investigations.

1. *A Study on the Effects of Position Limits on Trading on Exchanges in the United States*
   Section 719(a) requires the Commission to study the effects of the position limits imposed pursuant to the Act on excessive speculation and on the movement of transactions from exchanges in the United States to trading venues outside of the United States, and report to Congress within 12 months after the imposition of said limits and biennially thereafter. In conducting its studies, the Commission should solicit input from notable academics, market experts and commodity hedgers and end-users as to the effectiveness of position limits on perceived speculation.

2. *A Study on the Oversight of Carbon Markets*
   Section 750 of the Act requires the establishment of an interagency working group to study the oversight of existing and prospective carbon markets to ensure an efficient, secure and transparent carbon market, including the oversight of spot markets and derivative markets. While CMOC has taken no position for or against such markets, in a letter to lawmakers on October 30, 2009 it raised concerns regarding "the potential effects that carbon trading resulting from [such] market-based mechanisms and related financial instruments could have on the broader economy, overall market supply and demand fundamentals and systemic financial integrity." In conducting its study, the CFTC should examine the existence of such markets overseas and the effectiveness of their regulation. It should also consider what specific and additional regulations may be needed to protect the integrity of U.S. markets.

Conclusion
Again, we commend the Chairman, his fellow Commissioners and the CFTC staff for taking on the Dodd-Frank rulemakings in such an open and transparent manner. We appreciate this opportunity to provide our comments on regulatory initiatives important to CMOC and its mission. By implementing and enforcing the new authorities provided the Commission under Title VII of the Dodd-Frank Act in a manner that is consistent with our recommendations, the new rules will have their desired effect of reducing systemic risk and preventing manipulation, fraud and excess volatility and speculation in the commodities markets.

Thank you for your consideration.

The following organizations join together in these comments:

Air Transport Association
American Feed Industry Association
American Trucking Associations
Arkansas Oil Marketers Association
California Black Farmers & Agriculturalists Association
Colorado/Wyoming Petroleum Marketers Association
Columban Center for Advocacy & Outreach
Community to Community Development
Consumer Federation of America
Consumer Watchdog
Florida Petroleum Marketers Association
Food & Water Watch
Friends of the Earth
Fuel Merchants Association of New Jersey
Gasoline & Automotive Service Dealers of America, Inc.
Grassroots International
Illinois Petroleum Marketers C-Stores Association
Independent Connecticut Petroleum Association
Independent Oil Marketers Association of New England
Institute for Agriculture and Trade Policy
Louisiana Oil Marketers & Convenience Store Association
Maryknoll Office for Global Concerns
Massachusetts Oilheat Council
Maine Energy Marketers Association
Michigan Petroleum Association/Michigan Association of Convenience Stores
Montana Petroleum Marketers & Convenience Store Association
National Association of Oilheating Service Managers
National Association of Truckstop Operators
National Family Farm Coalition
National Farmers Union
National Grange
Nebraska Petroleum Marketers & Convenience Store Association
New England Fuel Institute
New Jersey Citizen Action Oil Group
New Mexico Petroleum Marketers Association
New Rules for Global Finance
New York Oil Heating Association
(Continued…)

North Dakota Petroleum Marketers & Retail Association
Ohio Petroleum Marketers & Convenience Store Association
Oil Heat Institute of Long Island
Oil Heat Council of New Hampshire
Oil Heat Institute of Rhode Island
The Organization for Competitive Markets
Petroleum Marketers Association of America
Petroleum Marketers & Convenience Store Association Kansas
Petroleum Marketers & Convenience Stores of Iowa
Propane Gas Association of New England
Public Citizen
R-CALF USA
South Dakota Petroleum & Propane Marketers Association
Utah Petroleum Marketers & Retail Association
Vermont Fuel Dealers Association
Western Petroleum Marketers Associations
West Virginia Oil Marketers and Grocers Association

Copies of these comments have been provided to:

U.S. Senate Committee on Agriculture, Nutrition & Forestry
U.S. Senate Committee on Appropriations, Subcommittee on Financial Services & General Government
U.S. Senate Committee on Banking, Housing & Urban Development
U.S. Senate Committee on Energy & Natural Resources
U.S. House of Representatives Committee on Agriculture
U.S. House of Representatives Committee on Appropriations, Subcommittee on Agriculture
U.S. House of Representatives Committee on Energy & Commerce
U.S. House of Representatives Committee on Committee on Financial Services