



Institute for Agriculture and Trade Policy

Testimony for the U.S. House of Representatives Committee on Agriculture, Subcommittee on General Farm Commodities and Risk Management hearing on the draft “Derivatives Markets Transparency and Accountability Act of 2009”

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The Institute for Agriculture and Trade Policy (IATP) is a 501c3 organization headquartered in Minneapolis, MN with an office in Geneva, Switzerland. IATP, founded over 20 years ago, works locally and globally to ensure fair and sustainable food, farm and trade systems. IATP is grateful for the opportunity to comment on a bill that is crucial for ensuring that commodities exchange activities contribute to the orderly functioning of markets that enable food and energy security.

In November, IATP published “Commodity Market Speculation: Risk to Food Security and Agriculture” (<http://www.iatp.org/iatp/publications.cfm?accountID=451&refID=104414>). The study found that commodity index fund speculation in U.S. commodity exchanges distorted prices and induced extreme price volatility that made the futures and options market unusable for commercial traders. For example, one market consultant estimated that index fund trading accounted for about 30 percent of the nearly \$8 a bushel price of corn on the Chicago Board of Trade at the height of the commodities bubble in late June. Until the bubble burst, many country elevators, unable to assess their risk in such volatile markets, had stopped forward contracting, endangering the cash flows and operations of many U.S. farms. The spike in developing country food import bills and increasing food insecurity, both in the United States and around the world, is partly due to the financial damage of deregulated speculation.

While researching this study, I monitored the Committee hearings that contributed to H.R. 6604, “Commodity Exchange Transparency and Accountability Act of 2008.” IATP congratulates the Committee for the intense and expedited schedule of hearings and legislative drafting that resulted in the passage of HR 6604 and revisions to it in the draft “Derivatives Markets Transparency and Accountability Act of 2009” (hereafter “the Act”). Due to the complexity of the legislation, our comments will only concern a small portion of the Act’s provisions.

Section 3. Speculative limits and transparency of off-shore trading and Section 6. Trading limits to prevent excessive speculation

U.S. commodity exchanges have a dominant international influence over both cash and futures prices for many commodities. Because of the affects of that influence on food security and agriculture around the world, it is crucial that U.S. regulation and oversight of commodity exchanges be exemplary for the regulation of other markets. However, incidents of off-shore non-commercial traders benefiting from U.S. commodity exchanges while claiming to be beyond the jurisdiction of the Commodity Exchange Act (CEA) have resulted in the need for the prudent measures of Section 3.

The Committee and its staff are to be congratulated for the work undertaken since the passage of H.R. 6604 on September 18 to improve the bill. Particularly noteworthy are the visits of Chairman Peterson and Committee staff to regulatory authorities in London and Brussels both to explain H.R. 6604 and to learn how it might be improved.

Section 3 would do by statute what the Commodities Futures Trading Commission's (hereafter "the Commission") memoranda of understanding with other regulatory authorities have failed to do: to ensure that foreign traders of futures, options and other derivatives cannot trade on U.S. exchanges unless they submit completely to the authorities of the CEA. Section 6 is so drafted as to avoid the possibility of a trade dispute ruling against the United States for "discrimination" against foreign firms in the peculiar trade and investment policy sense of that term. However, the World Trade Organization negotiations seek to further liberalize and deregulate financial services, particularly through the Working Party on Domestic Regulation of the General Agreement on Trade in Services (GATS).¹ The members of the Financial Leaders Group that has lobbied effectively for GATS and U.S. deregulation (and particular regulatory exemptions for their firms) are major recipients of taxpayer bailouts through the Troubled Asset Relief Program.

The Committee should invite testimony from the Office of the U.S. Trade Representative (USTR) concerning U.S. GATS commitments, to ensure that those commitments and/or USTR positions advocated at the GATS negotiations not conflict with Sections 3 and 6 or leave them vulnerable to WTO challenge. Furnished with that testimony and documents relevant to it, legislative drafting may be tightened to avoid the possibility of a WTO challenge.

As the Committee is well-aware, the number of contracts held by non-commercial speculators far outweighs those of bona fide physical hedgers. The overwhelming dominance of purely financial speculation has induced price volatility that can be neither explained nor justified in terms of physical supply and demand, bona fide hedging by commercial traders and/or the amount of purely financial speculation required to clear trades. For example, in May, *The Brock Report* stated, "no [commercial] speculator today can have a combined contract position in corn that exceeds 11 million bushels. Yet, the two biggest index funds [Standard and Poors/Goldman Sachs and Dow Jones/American Insurance Group] control a combined 1.5 billion bushels!"²

Section 3 of the Act seeks to close the regulatory exemption granted to Wall Street banks that enabled this massive imbalance between bona fide hedging on physical commodities and contracts held purely for financial speculation. However, closing that loophole will not suffice to begin to repair the damage wrought by the speculative position exemption. In 2004, the Security Exchange Commission granted for just a half dozen investment banks an exemption to prudential reserve requirements to cover losses, thus freeing up billions of dollars of speculative capital and handing the chosen banks a huge

¹ Ellen Gould. "Financial Instability and the GATS Negotiations." Canadian Centre for Policy Alternatives. July 2008. <http://www.tradeobservatory.org/library.cfm?refID=103596>

² "A Big Move Lies Ahead." *The Brock Report*. May 23, 2008.

competitive advantage.³ These two regulatory exemptions enabled the asset price bubbles that began to burst in July, with dire consequences for the entire financial system and the global economy. The Act should authorize the Commission to work with the SEC to close all exemptions to prudential capital reserve requirements.

Despite the commodities price collapse, Goldman Sachs, whose then CEO Henry Paulson led the successful campaign to exempt his firm and other paragons of risk management from prudential capital reserve requirements, is estimated to have made \$3 billion in net revenue in 2008 from its commodities division alone. The average bonus for a commodities trading managing director is estimated to be \$3-4 million in 2008, down 25 percent from 2007.⁴ Hence, there is little trader disincentive to exceed whatever speculative position limits that are agreed as a result of the deliberations of the Position Limit Agricultural and Energy Advisory Groups (stipulated by Section 6. 4a). The Act provides for no advisory group for base and precious metals, which suggests that those components of the index funds may continue without speculative limits. The Act can readily be amended to provide for a Position Limit Metals Advisory Group. Given the financial service industry incentives structure, there is much to be done in the Act to provide strong disincentives for firms and individual traders to exceed the agreed speculative position limits.

One of the responsibilities of the advisory groups is to submit to the Commission a recommendation about whether the exchanges themselves or the Commission should administer the position limit requirements “with enforcement by both the registered entity and the Commission” (lines 10-12, p. 15). While IATP agrees that the exchanges may have a role to play in administering the position limits requirement, we fail to understand why enforcement is not exclusively the Commission’s prerogative. We urge the Committee to modify this provision to remove any suggestion of exchange enforcement authority.

Section 4. Detailed Reporting and Disaggregation of Market Data and Section 5. Transparency and Record Keeping Authorities

The provisions in these sections will help regulators monitor the size, number and value of contracts during the reporting period “to the extent such information is available” (Sec. 4 g) 2). It is this qualifying last clause that worries IATP, since the Commission’s ability to carry out its statutory obligations depends on complete and timely reporting of index fund data that disaggregates the agricultural, energy, base metal and precious metal contract components of these funds. The duration of agricultural futures contracts are typically 90 days, while energy and metals futures are for six months to a year. Both Sections should stipulate that disaggregation not only concern contract positions held by traders with a bona fide commercial interest in the commodity hedged vs. contracts held by financial speculators. Disaggregated and detailed reporting requirements should also stipulate reporting data

³ Stephen LaBaton. “Agency’s ‘04 Rule Let Banks Pile Up New Debt, and Risk.” *The New York Times*. October 3, 2008.

⁴ Ann Davis. “Top Traders Still Expect the Cash.” *The Wall Street Journal*. November 19, 2008.

from all component commodities contracts of the index funds, taking into account the differences in typical contract duration. Furthermore, the Act should authorize the Commission to stipulate that the reporting period for the disaggregated and detailed data be consistent with the duration of the index funds' component contracts, rather than with the reporting period of the index fund itself. The Act should further stipulate that the privilege to trade may be revoked or otherwise qualified if that trader's reporting does not provide sufficient information for the Commission to determine whether the trader is complying with the CEA as amended.

Section 5 anticipates that traders will exceed the speculative position limits set by the Commission and provides for the terms of a special call by the Commission for trading data to determine whether the violation of the position limit has led to price manipulation or excessive speculation, as defined in the CEA. Although IATP finds these provisions necessary for prudential regulation, we believe that the Act should stipulate how the Commission should seek to obtain the documents requested in the special call, when the trading facilities are located outside the United States. The Act wisely provides a "Notice and Comment" provision concerning the implementation of the reporting requirements for deals that exceed the speculative position limits. We anticipate that this "Notice and Comment" period will be used and guide the Commission's implementation of Section 5 reporting requirements.

Section 7. CFTC Administration

IATP believes that the increase in Commission staff, above that called for in H.R. 6604, is well warranted. The Committee should consider adding to this section a provision for a public ombudsman who could take under consideration evidence of misuse or abuse of the Act's authorities by Commission employees and evidence of damage to market integrity that may result from non-implementation or non-enforcement of the Act's provisions.

Section 9. Review of Over-the-Counter Markets

Because of the prevalence of Over-the-Counter trades in commodities markets, and the damage to market integrity caused by lack of regulation of OTC trades, the need for speculative position limits on those trades seems all but self-evident. However, the Committee is wise to mandate the Commission's study of the OTC market given the heterogeneity, as well as the sheer volume of OTC contracts. We would suggest, however, that the study not be limited to transactions involving agricultural and energy commodities, but should also include base and precious metals.

Section 10. Study Relating to International Regulation of Energy Commodity Markets

IATP is very disappointed that Section 10 has dropped the study of agricultural commodity markets called for in H.R. 6604. The Commission will be better able to carry out its responsibilities if it understands how agricultural commodities are regulated or not on exchanges outside of the United States. While U.S. exchanges are dominant in determining futures and cash prices for many agricultural commodities, there are other influential exchanges for certain commodities. The Commission should study these exchanges to find out whether there are best practices from which U.S. exchanges could

benefit. IATP urges the Committee to restore the provision for a study of the international regulation of agricultural commodity markets to Section 10.

Section 13. Certain Exclusions and Exemptions Available Only for Certain Transactions Settled and Cleared Through Registered Derivatives Clearing Organizations

We confess to not understanding these amendments to the CEA and to skepticism about the need for the exclusions, exemptions and waivers, in light of the exclusions, exemptions, and waivers whose abuse has helped bankrupt both financial institutions and individual investors. IATP suggests that the Committee add a "Notice and Comment" provision to this section, so that the public has an opportunity to argue for or against individual provisions of this Section.

Section 14. Treatment of Emission Allowances and Off-Set Credits

This addition to H.R. 6604 may be premature, as the efficacy of emissions trading for actual reduction of global greenhouse gas emissions is under debate in the negotiations for a new United Nations Framework Convention on Climate Change. IATP believes that the Committee should await the results of the Framework Convention negotiations in December in Copenhagen before deciding whether to add this amendment to the CEA. If the Committee decides to retain this section, it should consider whether the current amendment should be limited to carbon sequestration or whether it should cover other green house gas emissions.

Again, I thank the committee for the opportunity to submit testimony. I congratulate the committee on moving forward on this important work. I'm available to answer any questions concerning this testimony.