THE FUTURE OF THE CFTC: END-USER PERSPECTIVES

HEARING

BEFORE THE

SUBCOMMITTEE ON
GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

OF THE

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THE FUTURE OF THE CFTC: END-USER PERSPECTIVES

WEDNESDAY, JULY 24, 2013

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Subcommittee met, pursuant to call, at 10:01 a.m., in Room 1300 of the Longworth House Office Building, Hon. K. Michael Conaway [Chairman of the Subcommittee] presiding.

Members present: Representatives Conaway, Neugebauer, Austin Scott of Georgia, Crawford, Gibson, Hartzler, Noem, Benishek, LaMalfa, Hudson, Davis, Collins, David Scott of Georgia, Vela, Gallego, Enyart, Vargas, Maloney, Walz, Negrete McLeod, Costa, Garamendi, Peterson (*ex officio*), and McIntyre.

Staff present: Caleb Crosswhite, Jason Goggins, Kevin Kramp, Pete Thomson, Suzanne Watson, Tamara Hinton, John Konya, C. Clark Ogilvie, Liz Friedlander, and Riley Pagett.

OPENING STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

The CHAIRMAN. This hearing of the Subcommittee on General Farm Commodities and Risk Management entitled, *The Future of CFTC: End-User Perspectives,* will come to order.

This morning I would like to welcome everyone to the third in a series of hearings to examine the CFTC's reauthorization in advance of writing legislation. Yesterday the Committee heard from CFTC Commissioners Scott O'Malia and Mark Wetjen. It proved to be a productive and insightful conversation that I hope will continue today.

Today we are joined by a diverse group of representatives from across the spectrum of end-users. Today's panelists will share the perspectives of the farmers, manufacturers, transportation firms, utility companies and others who produce the goods and services that every American consumes each day. Well-functioning markets are essential to help grow the economy and one needs to look no further than our witnesses here today to understand how important it is for the CFTC to get its regulations right.

I thank each of our witnesses for appearing here today to share your thoughts about how to improve both the operations and the regulations of the Commodity Futures Trading Commission. It is important for the Committee to hear your views, because ultimately, derivatives markets exist to support end-users, not finan-

cial firms. Although derivatives markets have been broadly mischaracterized as opaque, risky and exotic, the reality for end-users is far more mundane. Derivatives contracts are a part of everyday life for thousands of businesses. They enable risks to be transferred from those who are willing to pay to avoid it so that manufacturing, energy production and operations costs can all be predicted to a reasonable degree of certainty.

As a result, the price of buying a box of cereal, paying your power or gas bill, or buying an airline ticket home for Thanksgiving will hopefully remain relatively stable. This transfer of risk allows businesses to free up productive capital, to invest in new products, to build new facilities and to hire new employees. Unfortunately, despite Congress' clear intent to exempt end-users from the brunt of Dodd-Frank, the past few years have been a regulatory roller coaster for them.

As I mentioned in yesterday's hearing, I am concerned about the impact that delays and last-minute no-action letters are having on how market participants manage their businesses. The lack of business certainty has no doubt cost many companies valuable capital and changed their strategic thinking. Regulations should be created and exist to protect markets, not to destroy them.

I look forward to hearing the comments of our witnesses on the rule-making processes and how the CFTC will work to address the concerns they raise throughout. The perspective of today's witnesses are essential to crafting a forward-looking reauthorization bill, and I want to thank them again for taking the time to visit with us today.

With that, I'd like to turn to my colleague from Georgia, the Ranking Member, David Scott, for his opening remarks. David?

OPENING STATEMENT OF HON. DAVID SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

Mr. DAVID SCOTT of Georgia. Thank you very much, Mr. Chairman, and I join you in welcoming our distinguished witnesses. We are certainly looking forward to their important testimony.

Today's hearing is vitally important as it reminds us of why the markets regulated by the CFTC exist in the first place which is to serve companies both large and small, as well as individuals, small businesses, like farmers and their co-ops in managing their business risk. It is important to ensure that our markets function as they are intended and as end-users need them, too, in order that they can engage in the legitimate hedging activities necessary for their business operations.

However, I must say that right now, it is perhaps the case that things are not quite operating as they should. We do have an issue that is bubbling its head up that we need to watch very carefully at this point and that is whether banks should own and control vast storages or warehouses and oil tankers, pipelines and shipments, distribution of commodities, like aluminum, like gasoline. Is that fair, with the delays and timing of getting these commodities like aluminum, gasoline, to manufacturers and end-users. And the fundamental question is if these activities could pose another risk or a crisis to our nation's financial system, so as our Committee is charged with management, risk and commodities, we have to keep

a very jaundiced eye on this as to whether or not this results in mass inflated pricing.

And it is very important to note that with this we must know that banks, holding companies, are allowed certain commodity activities that are complimentary to financial activities, and they are permissible for bank-holding companies. But it is something that is there, and of course Members of this body as well as my constituents, have concerns about that and the oil markets as well.

So a careful examination of how commodity markets are functioning currently with the perspective of those using them to hedge commodity risk is vitally important as we continue discussions about the future of the CFTC and the stability and yes, the even playing field for all of our end-users so that we protect our banking system, we protect our end-users, we protect our financial system, and in fact the world economy and be careful not to ease into another crisis unintentionally.

With that, Mr. Chairman, I yield back.

The CHAIRMAN. I thank the gentleman. I would now like to welcome our panel of witnesses this morning. We have Mr. Scott Cordes, President, CHS Hedging, Inc., St. Paul, Minnesota, on behalf of the National Council of Farmer Cooperatives. We have Mr. Lance Kotschwar. Is that close, Lance?

Mr. KOTSCHWAR. Close.

The CHAIRMAN. Okay. Will Lance be okay? Senior Compliance Attorney, the Gavilon Group, LLC, Omaha, Nebraska, on behalf of the Commodity Markets Council. We have Mr. Richard F. McMahon, Vice President, Edison Electric, here in Washington, D.C. We have Chris Monroe, Treasurer, from Southwest Airlines in Dallas. We have Andrew Soto, Senior Managing Counsel, Regulatory Affairs, American Gas Association here in D.C. We have Mr. Gene Guilford, National & Regional Policy Counsel, Connecticut Energy Marketers Association, Cromwell, Connecticut, on behalf of the Commodity Markets Oversight Coalition.

Mr. Cordes, you are ready to begin, and you have about 5 minutes, if you can hold to the time.

STATEMENT OF SCOTT CORDES, PRESIDENT, CHS HEDGING, INC., ST. PAUL, MN; ON BEHALF OF NATIONAL COUNCIL OF FARMER COOPERATIVES

Mr. CORDES. Thank you, Chairman. Chairman Conaway, Ranking Member Scott, and Members of the Committee, thank you for holding this hearing to review key issues to end-users as you prepare for CFTC reauthorization. I am Scott Cordes, President of CHS Hedging, a commodity brokerage subsidiary of CHS Inc. CHS is a proud member of the National Council of Farmer Cooperatives, and I appear here today on behalf of NCFC.

Farmer cooperatives are an important part of the success of American agriculture. In particular, by providing commodity price risk management tools to their member-owners, farmer cooperatives help mitigate commercial risk in the production, processing and selling of a broad range of agricultural, energy and food products.

As you know, co-ops have long used exchanged-traded futures and options to hedge the price risk of commodities they purchase,

supply, process or handle for their members. In recent years, over-the-counter derivatives or swaps have also become increasingly important to hedge price risk. In fact, swaps play a critical role in the ability of cooperatives to provide forward contracts especially in volatile markets.

Therefore, the Committee oversight of CFTC during the Dodd-Frank rule-making process has been instrumental in ensuring that co-ops and farmers continue to have access to needed risk management tools. Continued oversight is important as the process turns from one of rule-making to one of compliance. This shift is something that NCFC members are now grappling with. They must clearly understand the provisions of the regulations while also figuring out how different regulations will fit together in a coherent framework. In some instances, co-ops are finding it challenging to understand how to be compliant, even as they spend a significant amount of resources to address the new regulations.

Part of the concern also lies with CFTC's eventual enforcement of the new regulations. As we have throughout the process, we urge CFTC to continue to work closely with the industry and take a collaborative approach to the compliance. This would be a continuation of the willingness that CFTC has shown to listen to our concerns during the rule-making process. Other rules that have not yet been finalized continue to cause uncertainty over the new costs that will be imposed on the agriculture industry. For instance, swap dealers, who co-ops often use to lay off risk, must comply with capital and margin requirements that are still unknown. What these costs will be and how they will be processed and passed on to end-users remains to be seen and could dramatically impact the cost effectiveness of hedging in the OTC market.

There still is the question of whether the so-called Prudential Regulators will require bank swap dealers to collect margin from end-users. We appreciate this Committee's work on the issue and House passage of the Business Risk Mitigation and Price Stabilization Act. Clearly, mandatory margin would increase cost to hedgers, operations and ultimately discourage prudent hedging practices.

Similarly we are waiting to see what will be contained in the revised position limits rule. As explained further in my written statement, two key areas of that rule we ask this Committee to focus on closely are the definition of *bona fide hedge* and the reporting of aggregated positions. The commercial hedgers could be adversely affected if those issues are not properly addressed.

In other instances, rules have been finalized and we are just now finding where it would be difficult or impossible to comply. In these instances we have to request no-action relief to the regulation from CFTC. For example, one CFTC regulation imposes phone recording requirements on some entities, such as grain elevators, who provide brokerage services so their farmer customers can hedge on exchanges. Because those elevators are technically branch offices associated with a futures commission merchant, they are bound by the same recording requirements as required as the FCM.

However, given the infrequent and low volume of futures transaction handled by those branches, complying with the phone recording requirements under this regulation would not be economi-

cally feasible. The cost to comply with this regulation would in many cases exceed the total revenues of those FCM branches. In addition, the recording and indexing of cell phone conversations pose a huge challenge. If enforced, this regulation would mean that many local branches would no longer be able to offer these risk management options. We hope you will support us in this effort.

Last, I would like to highlight an issue that has generated a lot of attention with the industry right now, additional protection for futures customers. NCFC supports much of what CFTC has proposed in the wake of MF Global and Peregrine's failures to protect customers. However, we are concerned with the potential unintended consequences that a one-size-fits-all regulation may have on hedgers and smaller FCMs. In addition to increased costs for hedgers, this proposed rule would be more financially and operationally burdensome to firms like farmer cooperative owned FCMs which work with hedgers. We are concerned with several aspects of the proposed regulations including changes around capital charges, residual interests, and establishment of risk management systems. Especially concerning is the requirement that an FCM's residual interest in customer-segregated account must at all times be sufficient to exceed the sum of potential margin calls. This is counter to the historical interpretation and would actually require customers as farmers to front additional dollars to fund their hedge accounts while providing little in the way of additional protection.

While my written testimony delves deeper into those concerns, I would be pleased to elaborate on the issue or answer any other questions you may have. Thank you again for the opportunity to testify today. Thank you, Mr. Chairman.

[The prepared statement of Mr. Cordes follows:]

PREPARED STATEMENT OF SCOTT CORDES, PRESIDENT, CHS HEDGING, INC., ST. PAUL, MN; ON BEHALF OF NATIONAL COUNCIL OF FARMER COOPERATIVES

Chairman Conaway, Ranking Member Scott, and Members of the Committee, thank you for the invitation to testify today on reauthorization of the Commodity Futures Trading Commission (CFTC) and key issues concerning the agriculture industry's ability to use and offer risk management tools.

I am Scott Cordes, President of CHS Hedging, a commodity brokerage subsidiary of CHS Inc. CHS is a farmer-owned cooperative and a grain, energy and foods company. We are owned by approximately 55,000 individual farmers and ranchers, in addition to about 1,000 local cooperatives who represent another 350,000 producers. You might also be interested to know I grew up on a grain and dairy farm in Southeastern Minnesota that my brother still operates today.

Today, I am testifying on behalf of the National Council of Farmer Cooperatives (NCFC). NCFC represents the nearly 3,000 farmer-owned cooperatives across the country whose members include a majority of our nation's more than two million farmers.

Farmer cooperatives—businesses owned, governed and controlled by farmers and ranchers—are an important part of the success of American agriculture. They are a proven tool to help individual family farmers and ranchers through the ups and downs of weather, commodity markets, and technological change. Through their cooperatives, producers are able to improve their income from the marketplace, manage risk, and strengthen their bargaining power, allowing them to compete globally in a way that would be impossible to do individually.

In particular, by providing commodity price risk management tools to their member-owners, farmer cooperatives help mitigate commercial risk in the production, processing and selling of a broad range of agricultural, energy and food products. America's farmers and ranchers must continue to have access to new and relevant risk management products that enable them to feed, clothe and provide fuel to consumers here at home and around the world. Last year's drought across much of the

country, which impacted so many producers so severely, once again illustrates the need for a multilayered risk management strategy in agriculture.

Cooperatives' Use of Derivative Markets

As processors and handlers of commodities and suppliers of farm inputs, farmer cooperatives are commercial end-users of the futures exchanges, as well as the over-the-counter (OTC) derivatives markets. They use exchange traded futures and options and OTC derivatives to hedge the price risk of commodities they purchase, supply, process or handle for their members.

In addition to the exchange-traded contracts, OTC derivatives have become increasingly important to hedge price risks. Due to market volatility in recent years, cooperatives are increasingly using these products to better manage their exposure by customizing their hedges. This practice increases the effectiveness of risk mitigation and reduces costs to the cooperatives and their farmer-owners. Swaps also play a critical role in the ability of cooperatives to provide forward contracts, especially in times of volatile markets. Because commodity swaps are not currently subject to the same margin requirements as the exchanges, cooperatives can use them to free up working capital.

OTC derivatives are not just used for risk management at the cooperative level, however. They also give the cooperative the ability to provide customized products to farmers and ranchers to help them better manage their risk and returns. Much like a supply cooperative leverages the purchasing power of many individual producers, or a marketing cooperative pools the production volume of hundreds or thousands of growers, a cooperative can aggregate its owner-members' small volume hedges or forward contracts. It can then offset that risk by entering into another customized hedge via the swap markets.

In addition, there are farmer-owned cooperative futures commission merchants (FCM), such as CHS Hedging, that provide brokerage services to farmers, ranchers, and commercial agribusiness. These operations perform a critical service of providing price risk management to a customer base comprised largely of physical commodity hedgers.

The Dodd-Frank Act

We greatly appreciate the ongoing oversight the House Agriculture 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.

As such, we have been working to ensure that the implementation of the Dodd-Frank Act preserves risk management tools for farmers, their cooperatives and others involved in the agriculture industry.

During the rulemaking process, NCFC has advocated for the following:

- Treat agricultural cooperatives as end-users because they aggregate the commercial risk of individual farmer-members and are currently treated as such by the CFTC;
- Exclude agricultural cooperatives from the definition of a swap dealer;
- Acknowledge that forward contracts continue to be excluded from CFTC swap regulation;
- Maintain a *bona fide* hedge definition that includes common commercial hedging practices; and
- Consider aggregate costs associated with the new regulations and the impact on the agriculture sector.

We recognize the complexity in crafting rules for the implementation of Dodd-Frank that best fit cooperatives, and appreciate the work of the Commission in addressing many of our concerns in the rule-writing process. While we now know farmer cooperatives will be treated as end-users and not swap dealers, there are additional questions and concerns that have arisen since many rules have been finalized and NCFC members have turned their attention to compliance.

As such, we are doing our best to put into place policies and procedures, but often find it a challenge to understand what exactly needs to be done to address the complex regulations. Given this situation, we also have concerns regarding how CFTC will enforce the regulations. We urge the Committee to encourage CFTC to work closely with industry to ensure clear understanding by all parties before beginning any enforcement actions.

Costs to End-Users

Uncertainty over ultimate costs and market liquidity is an ongoing concern for farmers and their cooperatives. 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 farmers. 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 evident. Even as end-users, significant resources must be used just to comply with the additional paperwork requirements. In fact, a number of NCFC members have had to greatly increase the amounts they have spent on compliance in the last 2 years on additional staff, outside assistance, and investments in technology.

It is also unclear how other costs will be forced down to end-users and impact their ability to hedge. We fear an increased cost structure due to higher transaction costs (or because certain risk management tools cease to exist altogether) may discourage prudent hedging practices. For example, 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 remain unclear.

Additionally, we are concerned with the so-called "Prudential Regulators" margin proposal requiring bank swap dealers to collect margin from end-users. As end-users, cooperatives use swaps to hedge interest rates, foreign exchange, and energy in addition to agricultural commodities. Often, cooperatives look to their lenders to provide those swaps. Under the proposed rule requiring end-users to post margin, costs to businesses will increase as more cash is tied up to maintain those hedges. The additional capital requirements will siphon away resources from activities and investment in cooperatives' primary business operations.

Congressional intent was clear on this point—end-users were not to be required to post margin. We appreciate the House of Representatives reaffirming this just last month by passing the Business Risk Mitigation and Price Stabilization Act.

Part 1.35 record-keeping Requirements

As a service to their customers, farmer-owned cooperative FCMs have a network of branch operations embedded in locations such as grain elevators, whose primary business is handling the cash grain volume of their producer customers. As a branch office of a cooperatively-owned FCM, these commercial grain elevators have chosen to provide brokerage services as a means of providing access to risk management tools for their farmer customers who want to hedge their production volume through futures and/or options.

Given the infrequent and low volume of futures/options transactions handled by "branches" associated with those FCMs, complying with the oral recording requirements (recording of all phone calls) under this regulation would not be economically feasible. The necessary investment to put in place and maintain a system to comply with the regulations would exceed not only any profits, but in many cases the total revenues of those FCM branches—to the point that those local branches could no longer provide brokerage services. The effect would be reduced risk management options, and their use, by farmers and ranchers.

Moving forward, we intend to ask CFTC for a no-action relief to this regulation, well before the compliance deadline of December, on the basis that CFTC recognized the burden that the oral communications record-keeping requirement would have on other smaller futures brokers. We hope that you will support our efforts in gaining this relief.

The Position Limits Rule

While the rule imposing position limits for swaps and futures was vacated by a court decision in September 2012, it is our understanding that CFTC is redrafting a new proposal. We continue to advocate that CFTC recognize common commercial hedging practices, such as anticipatory hedging and cross hedging, as *bona fide* hedges in that rule, and look forward to providing input when the proposal is made available for public comment. We would also encourage this Subcommittee to keep a close eye on that definition as the rule is rewritten.

Other aspects of this rule have also caused some confusion among NCFC's members. One example is the section that addresses aggregation of positions for the purposes of hedge limits for entities in which ownership of another is ten percent or greater (under the original rule), or 50 percent under CFTC's earlier re-proposal of the rule. Given the nature of independent risk management functions of subsidiaries or joint ventures of some of our cooperatives, it has caused further confusion over how each partner would communicate and share that information and/or account for each other's positions on a day-to-day basis.

The Forward Exclusion

Forward contracting allows farmers, cooperatives, and other businesses to price their product into the future, take positions to try to maintain a profit margin, and protect against unknown but potentially adverse price fluctuations. Therefore, understanding what constitutes an excluded forward contract is critical in order for businesses to continue their commercial supply and sales contracts.

We appreciate the guidance set forth regarding the forward exclusion in the product definitions rule. That guidance provided certainty about what constitutes an excluded forward contract, as forward contracts in non-financial commodities that contain embedded price options would be excluded forward contracts and not considered to be "swaps."

Recently, however, in light of the CFTC's seven-part interpretation in the rule, some NCFC members have raised concerns over the appropriate treatment of forward contracts commonly used in physical supply arrangements that contain volumetric optionality. If the CFTC were to take a narrow view of the seven-part interpretation, it may view as options many other routine physical supply contracts in which the predominant feature is delivery.[1] Such an interpretation would require those common commercial forward contracts to come under the regulations intended for swaps such as reporting and position limits.

The uncertainty of the CFTC interpretation of these types of contracts, all previously covered under the forward contracting exclusion, will require NCFC members to expend significant labor and costs to review hundreds of sales transactions to determine if they continue to meet the forward contract exclusion. Again, this is an unnecessary resource and cost burden on end-users that should be avoided. We hope CFTC will interpret this exclusion consistently with its historical understanding and prior guidance.

Customer Protection

NCFC supports strengthening protections for futures customers. We appreciate the House Agriculture Committee's hearings on this issue and the work CFTC has done in proposing new rules in this area subsequent to the failure of MF Global and Peregrine Financial Group. 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 FCMs are more complex than just regulatory burden, we are concerned with several aspects of the proposed regulations, including changes around capital charges, residual interest, and establishment of risk management systems under Rule 1.11, which will be financially and operationally burdensome for smaller FCMs.

One provision would require an FCM to take a capital charge with respect to any margin call that is outstanding for more than one business day, as opposed to the current practice of 3 business days. This proposed rule would clearly disadvantage smaller FCMs and many retail customers. Many smaller hedgers do not transfer funds by wire, but rather write checks. As such, it is common practice for farmer cooperative-owned FCMs to pay the clearing houses or the clearing FCMs in advance of receiving customer funds. By adding the additional capital charge after just

[1] Many commercial parties, including cooperatives, include some volumetric flexibility in physical supply agreements for both commercial and operational reasons. This allows them to address the uncertainty caused by likely changes in supply and demand fundamentals, including, for example, changes in suppliers and customers, transportation/vessel availability and capacity, operation and maintenance of a facility, and other commercial considerations that arise in the normal course of managing a physical commodity business. For example, some dairy cooperatives utilize volumetric flexibility in the sale of milk, both to minimize marketing costs and to balance supply and demand. It is not unusual for milk sales contracts to require a monthly range in deliverable volume. This is done to address the unknown supply and demand dynamics that will occur between seasons of the year (more milk is produced in the spring time than in the fall, while plant-level demand is greater in the fall as product is made for the holiday season). Additionally, dairy cooperatives that supply beverage milk plants need to have flexibility to divert deliveries to beverage plants during high demand parts of the week (beverage bottlers have their greatest demand on a Thursday to meet supermarket customers' heaviest grocery shopping period over the weekend).

one day, FCMs will possibly be forced to require their customers to wire transfer/ACH funds or maintain excessive funds in their account. The costs associated with either option would disproportionately affect smaller hedgers, while adding little in the way of added customer protection.

Another provision would require that an FCM's residual interest in the customer-segregated account must at all times be sufficient to exceed the sum of the margin deficits that the FCM's customers have in their accounts. This requirement is counter to the historical interpretation, which requires an FCM to maintain residual interest to cover customer-segregated accounts with negative net liquidating balances (debit equity). This gives an FCM time to collect customer funds prior to the time a payment must be made to the clearing house.

In addition to increased costs for hedgers, this proposed rule would be more burdensome to firms like farmer cooperative-owned FCMs, which largely deal only with hedgers. Although the risk profile of the customer base is very low, customers are predominantly on one side of the market and therefore more susceptible to big swings in the market. To require all deficits to be covered immediately would be overly burdensome on these FCMs given the low-risk profile of their customers as hedgers. We encourage Members of this Subcommittee to express concerns over this proposal to CFTC.

Thank you again for the opportunity to testify today before the Committee on behalf of farmer-owned cooperatives. We appreciate your role in ensuring that farmer cooperatives will continue to be able to effectively hedge commercial risk and support the viability of their members' farms and cooperatively owned facilities. I look forward to answering any questions you may have.

Thank you.

The CHAIRMAN. Thank you. Lance, 5 minutes.

STATEMENT OF LANCE KOTSCHWAR, SENIOR COMPLIANCE ATTORNEY, GAVILON GROUP, LLC, OMAHA, NE; ON BEHALF OF COMMODITY MARKETS COUNCIL

Mr. KOTSCHWAR. Thank you, Chairman Conaway, Ranking Member Scott, and Members of the Subcommittee. Thank you for the invitation today. My name is Lance Kotschwar. I work for Gavilon in Omaha, Nebraska, and I am a senior compliance attorney. I am testifying today on behalf of the Commodity Markets Council.

CMC is a trade association comprised of exchanges and their industry counterparts. Our activities include the complete spectrum of commercial end-users including all the futures markets and all of energy and agriculture products. We are well-positioned to provide the consensus views of commercial end-users of derivatives, and my views today represent the collective view of the CMC membership.

Our members depend on efficient and competitive functioning of U.S. futures exchanges, and we support well-regulated markets as long as the regulations are reasonable. As you seek to reauthorize to CFTC, we would like to emphasize several points starting with this. Any time that we change regulations that affect the hedging mechanism, that is going to introduce risk into the system that is going to have to be priced, and that is going to be a negative impact on both producers and consumers and everything in between. So to help inform you as you reauthorize, I want to offer a few thoughts and comments about our end-user concerns. My written statement goes into a lot of details about protection of customer collateral, but I want to spend my time focusing on our end-user concerns.

As Mr. Cordes said, we have a lot of concerns about this Part 1.35 record-keeping requirements. As the CFTC was going through the rule-making process, CMC was very engaged on it. We wanted to make sure that this expansion would not require non-clearing

members of a DCM to have to record phone calls related to physical commodity purchases and sales. Just going to a straight example, we didn't want grain companies that have exchange memberships to have to record phone calls to farmers.

Well, we won that battle, but we lost the bigger war because we weren't paying close attention to the fine print. The CFTC final rule quietly inserted some additional language that previously existed only in a guidance document that significantly expanded the scope of what they consider to be an electronic document, and they basically expanded to cover everything except oral conversations. It includes text messaging, instant messaging, e-mail and any other electronic communication. The cost of maintaining all this stuff is quite substantial and particularly you are trying to doing in a searchable format as the CFTC has requested, to the extent that is even technically feasible. In our case, we have totally instructed all of our grain locations they are not to use any kind of instant messaging at all right now. We have forced them back to the phones. So that is probably the exact opposite of what this rule is supposed to do.

Let me just to expand on what Mr. Cordes said. If you have a grain elevator with 100 locations, on any given day they are buying and selling grain all over the country. They are not doing futures for each individual sale. They look at their net exposure, and then that is what they go to the exchange with. So under the CFTC's rule, are we going to record all those phone calls when you have to get a tenuous connection to what the futures layoff is anyway? It doesn't seem to be a very good public policy process, especially since they are telling us we don't have to record phone calls but you have to do everything else. Let us face it. Text messaging and other kinds of electronic communications have largely replaced phone calls today in the 21st century. So if the policy is not to record phone calls, we need to be a little more logical about it.

Another area that we have some concerns about is *bona fide* hedging. Congress provided a definition of *bona fide hedging* within Dodd-Frank that the CFTC has unnecessarily narrowed. They have come up with at least five different definitions in various rules, and that creates a lot of confusion and could disrupt legitimate risk mitigation practices. We certainly are very interested in working with you to try to get this whole notion of *bona fide* hedging steered back in the right direction.

As Mr. Cordes has also said, we also have concerns about the scope of the *swap dealer* definition. We believe that the final rule defining who must register was—the Dodd-Frank Act, that was largely a category that was designed for large financial institutions. But we believe the way it has been implemented, it is altering trading activity between commercial market participants, and it is pushing more swap activity into the large dealer banks which is exactly the opposite of what Dodd-Frank wanted to do. Commercial participants are curtailing their trading activities for fear of having to get caught up in that definition of what a swap dealer is because they can't comply with the requirements.

We have some other concerns, too. I will just briefly mention them. We have some concerns about historical swap reporting, the real-time reporting rule as it relates to especially trading in illiquid

months, position limits, particularly aggregation, and last, residual interest which was written under the heading of customer protection but as written will have a costly and negative impact for our members and the FCMs that we use.

And with that, I yield back the rest of my time.

[The prepared statement of Mr. Kotschwar follows:]

PREPARED STATEMENT OF LANCE KOTSCHWAR, SENIOR COMPLIANCE ATTORNEY, GAVILON GROUP, LLC, OMAHA, NE; ON BEHALF OF COMMODITY MARKETS COUNCIL

Chairman Conaway, Ranking Member Scott, and Members of the Subcommittee: thank you for holding this hearing to review the reauthorization of the Commodity Futures Trading Commission ("CFTC"). My name is Lance Kotschwar, Senior Compliance Attorney for Gavilon Group, LLC. I am testifying today on behalf of the Commodity Markets Council ("CMC").

CMC is a trade association that brings together commodity exchanges and their industry counterparts. The activities of CMC members include 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 U.S., 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. My comments represent the collective view of the CMC membership.

All CMC member firms depend upon the efficient and competitive functioning of the risk management products traded on U.S. futures exchanges. CMC and its members support well-regulated markets, and while the financial crisis of 2008 had nothing to do with commodity markets, we recognize the need for the Dodd-Frank Act and support its goals. In turn, that regulation should be efficient and reasonable rather than overly prescriptive and complex.

Regulatory initiatives that lack clarity or evolve to be at cross-purposes with the core principles on which the Commission was founded are concerning to CMC members. Such regulatory disparities generate market inefficiencies and costs, which widen price margins between producers and consumers of energy and agricultural commodities, as well as those finished food, energy, and consumer products that derive from the underlying commodities.

Most agricultural commodities are produced seasonally yet consumed continuously, whereas energy commodities are produced continuously and consumed seasonally. We manage that flow of physical commodity and dynamically hedge it, allowing us to offer higher prices to producers and lower prices to consumers. As Congress seeks to once again reauthorize the CFTC, we would like to emphasize several points starting with this: undue regulatory interference with the hedging mechanism introduces risk that must be priced into the chain, negatively affecting both ends and everything in between.

At this critical juncture in Dodd-Frank rule writing and implementation, CMC members are concerned that the CFTC's efforts to implement new swap regulatory rules has now morphed into a crusade of rewriting many long-standing futures market regulations that Congress, via Dodd-Frank, never contemplated. Even more problematic is that this regulatory barrage is occurring almost entirely without consideration of real costs on commodity producers or consumers. The additional 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, and ultimately the cost of finished agricultural and energy goods.

Issues of Concern

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.

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. Ideas of al-

ternative collateral segregation regimes and insurance programs have been floated, and we encourage both this Committee and other relevant Congressional committees to fully examine and vet these proposals to allow for further protection of customer collateral.

CFTC 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 in a recent proposed rule that has generated serious concern 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 considerable liquidity issues and increase costs for FCMs, producers, 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 accounts, 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 designated self-regulatory organizations 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 rules. 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.

Part 1.35 record-keeping Requirements

A significant and concerning expansion of current data requirements beyond the scope of Dodd-Frank is related to record-keeping requirements in Part 1 of Commission regulations. In accordance with Dodd-Frank, the CFTC expanded the futures record-keeping 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 comes into effect later this year. Again, the market is searching for a reason for and measurable benefit of 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 e-mail,

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 an exchange member.

Finally, the cost figures contained in the cost-benefit analysis in the final rule are not justified. 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 what we view as unnecessary compliance costs.

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 increase competition and reduce the concentration of risk in a few large financial 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.

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 with which most end-users are incapable of complying. 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.

Current regulations have arbitrarily established a *de minimis* level, the breach of which requires registration as a swap dealer, at $8 billion with a drop to $3 billion following an unpredictable CFTC decision making process. The only certainty in the process is that a lack of action will result in the *de minimis* level declining in 5 years. This $3 billion level is also arbitrary and would significantly affect the number of firms defined and regulated as swap dealers. Changes should not be made through such a long and ill-defined process, which includes several unpredictable and difficult to follow steps for market participants. We need a more predictable process.

Reporting and record-keeping 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' ability to efficiently hedge.

Inter-Affiliate Transactions

Inter-affiliate trades are subject to record-keeping 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 the purpose of hedging or mitigating commercial risk and are documented pursuant to inter-affiliate agreements 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 is 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 constantly 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 any 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 disrupting legitimate risk mitigation practices. We are committed to working with Congress to set clearer direction on *bona fide* hedges so that transactions that limit economic risks are viewed as *bona fide* hedges by the CFTC.

Summary

Commodity derivatives markets continue to grow and prosper. They have become deeper and more liquid, narrowing bid/ask spreads, and improving hedging effectiveness and price discovery. 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 swap reforms in Dodd-Frank were not necessary because of problems in physical commodity markets. Commercial end-users of agricultural and energy futures had no role in creating the financial crisis. In fact, the regulated futures market fared well throughout the financial crisis and futures markets generally provide greater regulatory certainty for our members than evolving swaps regulations.

We believe that as Congress considers how the CFTC is to regulate in the future, it should use the core principles on which the CFTC was created as its guide. A balance must be maintained between regulatory zeal and consideration as to how regulatory changes could result in negative consequences to not just CMC members in the middle of the food and energy chain, but also to the producers and consumers on each side of the chain. Given this, we strongly believe that the CFTC's current trend toward very prescriptive changes to futures market regulation will hinder rather than improve our economy's ability to manage commodity market risks.

While the independent regulatory agency that this Committee has oversight responsibilities over must continue to evolve in order to adequately regulate increasingly complex derivatives markets, many of these pending changes also introduce the potential for regulators to create risk and increase costs by going beyond their purview. Doing so without consideration of the consequences is dangerous and violates both the "do no harm" principle of being a regulator as well as the CFTC's core principles regulatory methodology.

At present, this barrage of new CFTC rules 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 compliance questions remain.

The objective of the Commodity Exchange Act has never been to discourage hedging, but rather to create a market and regulatory environment that maintains market integrity while promoting the economic benefits of risk management. Purposely adding complexity and regulatory uncertainty to the marketplace only adds unnecessary costs. Uncertainty, via additional regulation of the risk management tools that commodity market participants utilize, actually creates risk where it didn't previously exist.

Thank you for this opportunity to testify. We look forward to continuing to work with this Committee to strike the right balance.

I look forward to your questions.

The CHAIRMAN. Thank you very much. You get extra-credit for that later on.

Mr. KOTSCHWAR. Thank you.

The CHAIRMAN. Mr. McMahon, 5 minutes.

STATEMENT OF RICHARD F. MCMAHON, JR., VICE PRESIDENT OF ENERGY SUPPLY AND FINANCE, EDISON ELECTRIC INSTITUTE, WASHINGTON, D.C.

Mr. MCMAHON. Good morning. Chairman Conaway, Ranking Member Scott, and Members of the Subcommittee, thank you for the opportunity to discuss the perspective of end-users on the future of the CFTC.

I am Richard McMahon, Vice President of Energy Supply and Finance for the Edison Electric Institute. EEI is the trade association of U.S. shareholder-owned electric utilities. My views are also shared by the Electric Power Supply Association, which is the national trade association for competitive wholesale electric suppliers.

The electric power industry is the most capital-intensive industry in the United States, an $840 billion industry. Our members are projected to spend approximately $90 billion per year through 2015 on cleaner generating capacity, environmental and energy-efficiency upgrades, as well as smart grid and cyber security improvements.

Our members are non-financial entities that primarily participate in the physical commodity market and rely on swaps and futures contracts primarily to hedge and mitigate their commercial risk. The goal of our member companies is to provide their customers with reliable electric service at affordable and stable rates. Since wholesale electricity and natural gas historically have been two of the most volatile wholesale commodity groups, our members manage these risks using derivatives for the benefit of their customers. In essence, our members are the quintessential commercial end-users of swaps.

Our members support the goals of Dodd-Frank. We believe, however, that there are areas where Congress should consider minor adjustments.

A new category of market participants, swap dealers, was created by Dodd-Frank. These swap dealers must register with the CFTC and are subject to extensive and burdensome regulatory requirements. The CFTC was directed to exempt entities that engage in a *de minimis* quantity of swap dealing. The CFTC set this threshold at $8 billion. However, it will be reduced automatically to $3 billion in 2018 absent CFTC action.

We oppose such a dramatic reduction in the *de minimis* threshold without deliberative CFTC action including a formal rulemaking process that allows stakeholders to provide input on what the appropriate threshold should be.

As I previously mentioned, the electric power industry is one of the most capital-intensive industries. Requiring non-financial end-users to post margin could tie up much-needed capital that would otherwise be used to invest in local economies and to create jobs. Congress should clarify that it did not intend for margin requirements to apply to non-financial end-users.

Last year, the U.S. District Court vacated final CFTC rules regarding position limits. These vacated rules defined the term *bona fide hedging* in a way that was unnecessarily narrow and would have discouraged a significant amount of beneficial risk management activity. This restrictive definition of *bona fide hedging* transactions could make hedging more difficult and costly and inadvert-

ently increase systemic risk by encouraging end-users to leave large portions of their portfolios unhedged. Congress should direct CFTC to allow transactions to be considered *bona fide* hedging if they meet general requirements, not limited to this enumerated list.

The Dodd-Frank Act defines the term *financial entity* as an entity that is predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature. Dodd-Frank allows affiliates or subsidiaries of an end-user to rely on the end-user exemption when entering into a swap on behalf of the end-user. However, swaps entered into by end-user hedging affiliates who fall under the definition of *financial entity* cannot take advantage of the end-user exemption. Congress should amend the definition of *financial entity* to ensure that commercial end-users are not inadvertently regulated as a financial entity.

Currently, the CFTC's rules generally treat affiliate swaps like any other swap. So companies must, under certain circumstances, report swaps between majority-owned affiliates and must submit such swaps to clearing unless the end-user hedging exception applies or a complex criteria for inter-affiliate clearing exemptions are met.

The CFTC has provided some relief in the form of no-action letters. However, these no-action letters are often insufficient and cause uncertainty among end-users. EEI supports bipartisan legislation to address the inter-affiliate transaction issue.

In closing, I would like to thank you and your leadership and the ongoing interest in the issues surrounding the implementation of Dodd-Frank and their impact on commercial end-users.

And again, I appreciate the opportunity to testify and would be happy to answer any questions.

[The prepared statement of Mr. McMahon follows:]

PREPARED STATEMENT OF RICHARD F. MCMAHON, JR., VICE PRESIDENT OF ENERGY SUPPLY AND FINANCE, EDISON ELECTRIC INSTITUTE, WASHINGTON, D.C.

Introduction

Chairman Conaway, Ranking Member Scott, and Members of the Subcommittee, thank you for the opportunity to discuss the perspective of end-users on the future of the Commodity Futures Trading Commission (CFTC).

I am Richard McMahon, Vice President of Energy Supply and Finance for the Edison Electric Institute (EEI). EEI is the trade association of U.S. shareholder-owned electric utilities, with international affiliates and industry associates worldwide. EEI's U.S. members serve virtually all of the ultimate electricity customers in the shareholder-owned segment of the industry, and represent approximately 70 percent of the total U.S. electric power industry.

The electric power industry is the most capital-intensive industry in the United States—an $840 billion industry representing approximately three percent of real gross domestic product. Our industry is projected to spend approximately $90 billion a year through 2015 for major transmission, distribution and smart grid upgrades; cybersecurity measures; new, cleaner generating capacity; and environmental and energy-efficiency improvements.

My views are shared by the Electric Power Supply Association (EPSA), which is the national trade association for competitive wholesale electricity suppliers, including power generators and marketers. EPSA members include both independent power producers and the wholesale supply businesses of utility holding companies. EPSA members supply electricity nationwide with an emphasis on the ⅔ of the country located within a regional transmission organization or independent system operator (so-called "organized markets"). EPSA members and other competitive suppliers account for 40 percent of the installed electric generating capacity in the

United States. These suppliers are the primary sources of electricity for most of Maine to Virginia, across to Illinois, and in Texas and California.

Our members are non-financial entities that primarily participate in the physical commodity market and rely on swaps and futures contracts primarily to hedge and mitigate their commercial risk. The goal of our member companies is to provide their customers with reliable electric service at affordable and stable rates, which has a direct and significant impact on literally every area of the U.S. economy. Since wholesale electricity and natural gas historically have been two of the most volatile commodity groups, our member companies place a strong emphasis on managing the price volatility inherent in these wholesale commodity markets to the benefit of their customers. The derivatives market has proven to be an extremely effective tool in insulating our customers from this risk and price volatility. In sum, our members are the quintessential commercial end-users of swaps.

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") provides certain exemptions for non-financial end-users, recognizing that they are not the entities posing systemic risk to the financial system. Since passage of the Dodd-Frank Act, we have been actively working with the Federal agencies, including the CFTC, as they work their way through the implementation process to ensure that the Congressional intent of exempting non-financial end-users remains intact. Even though a majority of the rules have been promulgated by these agencies, concerns still surround some of the remaining issues important to electric companies.

Our members support the Dodd-Frank Act's primary goals of protecting the financial system against systemic risk and increasing transparency in derivatives markets. We believe, however, that there are areas where Congress should consider minor adjustments to ensure the Dodd-Frank Act achieves its purpose while not inadvertently impeding end-users' ability to hedge. As Congress examines possible modifications to the Commodity Exchange Act, we ask that you consider the following issues:

De Minimis *Level*

A new category of market participants, swap dealers, was created by the Dodd-Frank Act. These swap dealers must register with the CFTC and are subject to extensive record-keeping, reporting, business conduct standards, clearing, and—in the future—regulatory capital and margin requirements. However, the Act directed the CFTC to exempt from designation as a swap dealer entities that engage in a *de minimis* quantity of swap dealing. The CFTC issued a proposed rule on the *de minimis* threshold for comment in early 2011. After review of hundreds of comments, a series of Congressional hearings and after dozens of meetings with market participants, the CFTC set this *de minimis* threshold at $8 billion. However, it will then be reduced automatically to $3 billion in 2018 absent CFTC action.

We oppose such a dramatic reduction in the *de minimis* threshold without deliberate CFTC action. Inaction is always easier than action, and inaction should not be the default justification for such a major regulatory action. In addition, we believe the CFTC should not have the authority to change the *de minimis* level without a formal rulemaking process that allows stakeholders to provide input on what the appropriate threshold should be.

Absent these procedural changes, we are concerned a deep reduction in the *de minimis* level could result in commercial end-users being misclassified as swap dealers, hindering end-users' ability to hedge market risk while imposing unnecessary costs that eventually will be borne by consumers.

Margin Requirements

As I previously mentioned, the electric power industry is one of the most capital-intensive industries in the United States. With our industry projected to spend approximately $90 billion a year through 2015 for major upgrades to the electric system, requiring non-financial end-users to post margin could tie up much-needed capital that otherwise would be used to invest in local economies. With the lack of clarity on whether or not Prudential Regulators and possibly the CFTC plan on requiring non-financial end-users to post margin, Congress should clarify that it did not intend for margin requirements to apply to non-financial end-users.

In addition, we ask Congress to clarify that it 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 non-financial end-users if they agree to collateralize a swap as a commercial matter. We support bipartisan legislation that seeks to further clarify that end-users are exempt from margin requirements. H.R. 634, sponsored by Rep. Michael Grimm (R–NY), passed the House on an over-

whelmingly bipartisan vote of 411–12. Similar legislation has also been introduced in the Senate—S. 888, sponsored by Sen. Mike Johanns (R–NE).

Bona Fide *Hedging*

On September 28, 2012, the U.S. District Court for the District of Columbia vacated final CFTC rules regarding position limits. These vacated rules defined the term *bona fide* hedging. As written in the CFTC's rule that was vacated, the definition was unnecessarily narrow and would have discouraged a significant amount of important and beneficial risk management activity. Specifically, the rule narrowed the existing definition considerably by providing that a transaction or position that would otherwise qualify as a *bona fide* hedge also must fall within one of eight categories of enumerated hedging transactions, a definitional change neither supported in nor required by the Dodd-Frank Act. This restrictive definition of *bona fide* hedging transactions could disrupt the commodity markets, make hedging more difficult and costly, and may increase systemic risk by encouraging end-users to leave a relatively large portion of their portfolios un-hedged.

Financial Entities

The Dodd-Frank Act defines the term "financial entity", in part, as an entity that is "predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956." Incorporating banking concepts into a definition that also applies to commercial commodity market participants has had unintended consequences.

Unlike our members, banks and bank holding companies generally cannot take or make delivery of physical commodities. However, banks and bank holding companies can invest and trade in certain commodity derivatives. As a result, the definition of "financial in nature" includes investing and trading in futures and swaps as well as other physical transactions that are settled by instantaneous transfer of title of the physical commodity. An entity that falls under the definition of a "financial entity" is generally not entitled to the end-user exemption-an exemption that Congress included to benefit commercial commodity market participants—and can therefore be subject to many of the requirements placed upon swap dealers and major swap participants. In addition, the CFTC has used financial entity as a material term in numerous rules, no-action relief, and guidance, including, most recently, its cross-border guidance. The Dodd-Frank Act allows affiliates or subsidiaries of an end-user to rely on the end-user exception when entering into the swap on behalf of the end-user. However, swaps entered into by end-user hedging affiliates who fall under the definition of "financial entity" cannot take advantage of the end-user exemption, despite the fact that the transactions are entered into on behalf of the end-user.

Many energy companies structure their businesses so that a single legal entity within the corporate family acts as a central hedging, trading and marketing entity—allowing companies to centralize functions such as credit and risk management. However, when the banking law definitions are applied in this context, these types of central entities may be viewed as engaging in activity that is "financial in nature," even with respect to physical transactions. Hence, some energy companies may be precluded from electing the end-user clearing exception for swaps used to hedge their commercial risks and be subject to additional regulations applicable to financial entities. Importantly, two similar energy companies may be treated differently if, for example, one entity uses a central affiliate to conduct these activities and another conducts the same activity in an entity that also owns physical assets or that has subsidiaries that own physical assets. Accordingly, Congress should amend the definition of "financial entity" to ensure that commercial end-users are not inadvertently regulated as "financial entities."

Inter-Affiliate Transactions

Currently, the CFTC's rules and proposed rules generally treat inter-affiliate swaps like any other swap. Hence, 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. In the absence of a more expansive clearing exemption for inter-affiliate trades, the costs of clearing likely would deter most market participants from entering into inter-affiliate transactions and could create more risk for clearinghouses. For example, without an exemption, additional affiliates in a corporate family would need to become clearing members or open accounts with a Futures Commission Merchant, and all affiliates would need to develop and implement redundant risk management procedures and trade processing services, such as e-confirm.

The CFTC has provided some relief in the form of no-action letters. However, in many circumstances, these no-action letters do not provide adequate relief and frequently cause more confusion and uncertainty among end-users. EEI supports bipartisan legislation to clarify the requirements placed on inter-affiliate transactions. The Inter-Affiliate Swap Clarification Act (H.R. 677), which seeks to clarify a number of these requirements, has been introduced by Rep. Steve Stivers (R–OH) in the House.

Finally, for the reasons enumerated in the testimony of the American Gas Association, we agree that options and forward contracts that are intended to be physically settled or contain volumetric optionality should be excluded from the definition of a swap.

Conclusion

Thank you for your leadership and ongoing interest in the issues surrounding implementation of the Dodd-Frank Act and their impact on commercial end-users. We appreciate your role in helping to ensure that electric utilities and energy suppliers can continue to use over-the-counter derivatives in a cost-effective manner to help protect our electricity consumers from volatile wholesale energy commodity prices.

Again, I appreciate the opportunity to testify and would be happy to answer any questions.

The CHAIRMAN. I thank the gentleman. Mr. Monroe for 5 minutes.

STATEMENT OF CHRIS MONROE, TREASURER, SOUTHWEST AIRLINES CO., DALLAS, TX

Mr. MONROE. Chairman Conaway, Ranking Member Scott, and Members of the Subcommittee, thank you for convening this hearing. My name is Chris Monroe, and I am the corporate Treasurer of Southwest Airlines. I am pleased to be here today to explain how the Dodd-Frank Act has caused a major impact to a commercial end-user like Southwest Airlines.

Mr. Chairman, as a Texan, you know we began operating in 1971 with three planes serving three Texas cities. Back then, as now, our purpose was to connect people to what is important to their lives with friendly, reliable and affordable air transportation. Friendly in this context doesn't just mean having nice employees. It means allowing customers to change their flights and check a bag without paying a penalty.

Today, Southwest is the nation's largest domestic airline in terms of passengers, and we are the only major airline with a truly national route structure that has not gone through bankruptcy or imposed mass-employee layoffs or furloughs, or reduced workers' wages or benefits.

One key to our unparalleled success has been our ability to hedge fuel through legitimate end-user derivatives purchased in the futures markets. Hedging at Southwest is enterprise risk management, essential in our view given our $6 billion annual fuel bill. To hedge, we commonly enter into transactions many months or years in advance of needing the physical product. Trading in these illiquid markets allows us to manage our fuel costs, which in turn helps us to keep fares low and maintain large jet flights in the communities we serve.

I am here today to highlight a few issues that have begun to impact these important markets that companies such as Southwest rely on to manage risk. One area we are seeing negative commercial impact is the CFTC's Real-Time Reporting Rule. That regulation prescribes the maximum time delay before swap trade data is publicly disseminated. The prescribed time delays may be sufficient

for liquid markets, but the timeframes are not sufficient for illiquid markets, which, as I said before, is where Southwest commonly trades. Only a few market participants trade that far out on the curve, which makes contracts highly illiquid, even in contracts that may be liquid in the front months such as crude oil.

Additionally, Southwest has a particularly identifiable trading strategy, a hedging DNA if you will, which makes us quite visible in a market with few participants. This is particularly harmful. It is my understanding that Dodd-Frank expressly mandated that the identity of legitimate end-users like Southwest would be kept confidential and for good reasons as will become clear.

When a dealer has to report 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 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 either curtail trades or materially increase the costs of the trade to the end-users. If an end-user like Southwest can no longer access the markets to hedge fuel, it would be contrary to the purposes of the legislation and in our view hostile to Congressional intent.

Since the rule became effective, Southwest is already seeing changes in market behavior and swap pricing. A recent trade cost Southwest an additional 35 basis points in spread. Applying that additional 35 basis points in cost to 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 costs. Following the rule's implementation, Southwest heard from dealers who plainly were aware of our trades that we had entered into that will settle in 2015 and beyond.

Southwest does not object to real-time reporting of swap transactions to the CFTC. We support transparency. 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 others to take advantage of their market position.

In conclusion, it would be fair to say that neither the drafters of Dodd-Frank nor the CFTC officials intended to impede Southwest's ability to hedge our high fuel costs as a legitimate end-user, but unfortunately this has been the result of the Real-Time Reporting Rule. I look forward to today's discussion on this issue as well as other issues affecting commercial end-users. We also encourage the Subcommittee to consider legislative solutions to address the unintended consequences of the Real-Time Reporting Rule.

Thank you for this opportunity to testify, and I look forward to answering your questions.

[The prepared statement of Mr. Monroe follows:]

PREPARED STATEMENT OF CHRIS MONROE, TREASURER, SOUTHWEST AIRLINES CO., DALLAS, TX

Chairman Conaway, Ranking Member Scott, and Members of the Subcommittee, thank you for convening this hearing. My name is Chris Monroe and I am the corporate Treasurer of Southwest Airlines. I am pleased to be here today to explain

how the Dodd-Frank Act has caused a major impact to a commercial end-user like Southwest Airlines.

Mr. Chairman, as a Texan you know we began operating in 1971 with three planes serving three Texas cities. Back then, as now, our purpose was to connect people with what's important to their lives with friendly, reliable, and affordable air transportation. "Friendly" in this context doesn't just mean having nice Employees. It means allowing Customers to change their flights and check a bag without paying a penalty.

Today, Southwest is the nation's largest domestic airline in terms of passengers. We are the ONLY major airline with a truly national route structure that has not gone through bankruptcy, or imposed mass-Employee layoffs or furloughs, or reduced workers' wages and benefits. One key to our unparalleled success has been our ability to hedge fuel through legitimate end-user derivatives purchased in the futures markets. Hedging at Southwest is enterprise risk management—essential in our view given our $6 billion annual fuel bill. To hedge, we commonly enter into transactions many months or years in advance of needing the physical product. Trading in these illiquid markets allows us to manage our fuel costs, which in turn helps us to keep fares low and maintain large jet (Boeing 737) flights in the communities we serve.

I am here today to highlight a few issues that have begun to impact these important markets that companies such as Southwest relay on to manage risk. One area where we are seeing a negative commercial impact is the Commodity Futures Trading Commission's ("CFTC's") Real-Time Public Reporting of Swap Transaction Data Rule ("Real-Time Reporting Rule"). That regulation prescribes the maximum time delay before swap trade data is publicly disseminated. Under this rule, swap dealers and major swap participants (generally referred to as "dealers") have a much shorter time in which to report trade data after execution than trades between two commercial end-users. Importantly, trades between a legitimate commercial end-user and a dealer must 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 on the accelerated time limit.

The dealer time delays may be sufficient for liquid markets, but the timeframes are not sufficient for illiquid markets, which, as I said before, is where Southwest commonly trades. Only a few market participants trade that far out the curve, which makes the contracts highly illiquid, even in contracts that may be liquid in the front months such as crude oil. Additionally, Southwest has a particularly identifiable trading strategy, a hedging "DNA" if you will, which makes us quite visible in a market with few participants. This is particularly harmful. It is my understanding that Dodd-Frank expressly mandated that the identity of legitimate end-users like Southwest would be kept confidential—and for good reasons as will become clear.

When a dealer has to report 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 either curtail trades or materially increase the costs of the trade to the end-users.) If an end-user like Southwest can no longer access the markets to hedge fuel it would be contrary to the purposes of the legislation and in our view hostile to Congressional intent.

Since the rule became effective, 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 costs. Following the rule's implementation, Southwest heard from dealers who plainly were aware of trades we had entered into that will settle in 2015.

Southwest does not object to real-time reporting of swap transactions to the CFTC. We support transparency. 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 others to take advantage of their market position.

Other issues still open for debate at the regulatory level which have the potential to completely change how we hedge relate to margin for uncleared swaps. Congress clearly intended to exempt commercial end-users from mandatory minimum margin requirements to retain the flexibility of end-users and their counterparties to avoid unnecessarily tying up scarce working capital. In that vein, Congress included spe-

cific language in Dodd-Frank[1] to allow non-cash collateral to be posted as margin as agreed to by the counterparties. This is an important practice to Southwest, as we use unencumbered assets such as aircraft to collateralize our hedge positions. This allows us to retain cash in the company to invest in our business, grow our route network, and create new jobs, and keep our fares low for customers. However the proposed rule related to uncleared margin requirements from the Prudential Regulators, who regulate nearly all of our trading counterparties, seems to both require commercial end-users to post margin and explicitly disallows the use of non-cash collateral as margin. We believe all involved regulatory bodies should follow the intent of Congress and retain the flexibility in counterparty trading relationships with respect to margin for commercial end-users.

In conclusion, it would be fair to say that neither the drafters of Dodd-Frank nor the CFTC officials intended to impede Southwest's ability to hedge our high fuel costs as a legitimate end-user, but unfortunately that has been the result of the Real-Time Reporting Rule. I look forward to today's discussion on this issue as well as other issues affecting commercial end-users. We also encourage the Subcommittee to consider legislative solutions to address the unintended consequences of the Real-Time Reporting Rule.

Thank you for this opportunity to testify and I look forward to answering your questions.

The CHAIRMAN. Thank you, sir. Mr. Soto for 5 minutes.

STATEMENT OF ANDREW K. SOTO, SENIOR MANAGING COUNSEL, REGULATORY AFFAIRS, AMERICAN GAS ASSOCIATION, WASHINGTON, D.C.

Mr. SOTO. Chairman Conaway, Ranking Member Scott, Members of the Subcommittee, thank you for inviting me to appear before you today. I am here on behalf of the American Gas Association's more than 200 local energy companies that deliver clean natural gas throughout the United States. As Raking Member Scott had indicated earlier at the opening of this hearing, we believe that gas utilities, large and small, pose little or no systemic risk to the nation's financial system.

AGA has worked cooperatively with the CFTC and its staff throughout the rule-making process to implement the Dodd-Frank Act, and we appreciate the magnitude and difficulty of the task. However, from a business perspective, regulatory certainty is essential for planning and compliance. And let me just take the example of the *swap* definition as an area of uncertainty. What is and what isn't a swap is fundamental to the whole regulatory regime, and yet throughout the process, there has been an evolution of what transactions fall in and fall out. There was a three-part test for certain forwards that were excluded, and then in the interim final rule, the last discussion on the subject, there was a further seven-part test and the Commission asked for additional comments. They have not yet acted on those comments, and as a result, there is tremendous confusion and disagreement in the energy

[1] Within Section 731 of the Dodd-Frank Act:

"(D) COMPARABILITY OF CAPITAL AND MARGIN REQUIREMENTS.—

"(i) IN GENERAL.—The prudential regulators, the Commission, and the Securities and Exchange Commission shall periodically (but not less frequently than annually) consult on minimum capital requirements and minimum initial and variation margin requirements.

"(ii) COMPARABILITY.—The entities described in clause (i) shall, to the maximum extent practicable, establish and maintain comparable minimum capital requirements and minimum initial and variation margin requirements, *including the use of non cash collateral,* for—

"(I) swap dealers; and

"(II) major swap participants"

industry as to which type of gas supply transactions will be subject to the CFTC's regulations.

Consequently, some industry counterparties have taken the view that they will treat all of their energy transactions that contain any option or choice for one of the parties as a trade option. Other counterparties are insisting on contract provisions to be included in their contracts to force agreement as to how the transactions should be treated. One of my members has told me that they have entered into routine transactions with multiple counterparties where the different counterparties themselves have conflicting interpretations of what are essentially identical contracts.

Uncertainty is hampering business planning and compliance and is disrupting contracting practices in the industry, and it also hampers the CFTC's ability to be an effective market monitor. Therefore, we believe that the CFTC and the industry would benefit greatly from additional administrative processes whereby industry participants could obtain in a timely manner the kind of regulatory certainty they need for planning and compliance and challenge agency action if necessary.

In particular, we offer the following three recommendations. First, AGA recommends that Congress amend the Commodity Exchange Act to provide clear and defined procedures for challenging CFTC rules and orders in a United States Court of Appeals. A broad judicial review provision allowing for the direct challenge of CFTC rules and orders would both have a rehabilitative effect on problems with the current process and a prophylactic effect in strengthening the agency's rule-making process.

Second and relatedly, AGA recommends that Congress provide direct judicial review of jurisdictional disputes between the Commodity Futures Trading Commission and the Federal Energy Regulatory Commission. For energy end-users such as AGA's members, the main source of frustration with the CFTC's implementation of the Dodd-Frank Act has been a lack of regulatory certainty as to whether physical transactions traditionally regulated by FERC would now be subject to CFTC regulation as swaps. Industry participants would greatly benefit by clearly defined scopes of jurisdiction between the two agencies.

Third, AGA recommends that Congress require the CFTC to provide better internal administrative processes for interested parties to see clarity and guidance on agency issues. Under current CFTC rules, there are insufficient avenues available for the public to obtain timely definitive guidance in the form of a final agency action. As a result, parties have relied on staff action in the form of no action or exceptive relief, interpretive guidance and/or interpretations by the General Counsel to obtain necessary clarification of the agency rules. And this is the point I believe that Commissioner O'Malia had made at yesterday's hearing.

AGA believes that the inclusion of administration process reforms in the CFTC's governing statutes and rules would have a positive impact on the agency's ability to be a responsive and effective regulator. And we would be pleased to provide the Committee with specific recommendations at your request.

I thank you for the consideration of this testimony and look forward to answering any questions you might have.

[The prepared statement of Mr. Soto follows:]

PREPARED STATEMENT OF ANDREW K. SOTO, SENIOR MANAGING COUNSEL, REGULATORY AFFAIRS, AMERICAN GAS ASSOCIATION, WASHINGTON, D.C.

Chairman Conaway, Ranking Member Scott, and Members of the Committee, I am Andrew K. Soto, Senior Managing Counsel for Regulatory Affairs at the American Gas Association (AGA). Founded in 1918, AGA represents more than 200 local energy companies that deliver clean natural gas throughout the United States. More than 65 million residential, commercial and industrial natural gas customers, or more than 175 million Americans, receive their gas from AGA members. In my role at AGA, I represent the interests of AGA's members before a variety of Federal agencies, including the Commodity Futures Trading Commission (CFTC).

Thank you for inviting me to appear before you today on the issue of the impact of the CFTC's implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act on non-financial entities or end-users. AGA member companies are end-users of futures and swaps in that they use such financial instruments to hedge and mitigate their commercial risks, in particular price volatility associated with procuring natural gas commodity supplies for their customers. AGA members have an interest in transparent and efficient financial markets for energy commodities, so that they can engage in risk management activities at reasonable cost for the benefit of America's natural gas consumers. We believe Congress intended in the Dodd-Frank Act to protect end-users' ability to use financial transactions to hedge and mitigate commercial risk in recognition of the fact that non-financial end-users did not cause the financial crisis that led to the passage of the Dodd-Frank Act and pose little or no systemic risk to the financial system.

My testimony will address three areas. First, I will explain the importance of transparent and efficient financial markets to gas utilities that procure and deliver clean, affordable natural gas to their customers. Second, I will address the impact of the CFTC's implementation of the Dodd-Frank Act on gas utilities' ability to enter into financial and physical contracts to manage commercial risks associated with the business of procuring natural gas. Third, I will recommend administrative process reforms, which we believe will help make the CFTC a more responsive regulator and provide additional avenues to obtain regulatory certainty, which is essential for business planning and compliance.

Gas Utility Reliance on Financial Markets

AGA member companies provide natural gas service to retail customers under rates, terms and conditions that are regulated at the local level by a state commission or other regulatory authority with jurisdiction. Each year, natural gas utilities develop seasonal plans to reliably meet the gas supply needs of their retail customers. Gas utilities build and manage a portfolio of physical gas supplies and services in order to meet anticipated demand. A portfolio of assets and contracts may include natural gas supply contracts, pipeline transportation storage and no-notice services, and on-system assets such as natural gas storage, liquefied natural gas storage, and propane air storage. Because a significant portion of customer demand is weather driven, gas utilities cannot know with certainty when, or even if, a certain amount of the gas supplies they make plans to have access to will be needed. Gas utilities, therefore, typically enter into certain gas supply contracts with flexible delivery terms as part of their supply portfolios in order to meet demand swings driven by variable customer loads throughout the season or year. Factors affecting variable loads include expected and unexpected volatility in customer demand, weather events, constraints or disruptions to alternative sources of supply, and heightened seasonal (winter) demand fluctuations. Flexible delivery terms are an essential element of some of the gas supply contracts used to meet variable system load requirements.

Gas utilities have a strong interest in managing their supply portfolios to ensure that the overall cost for natural gas service remains stable and at a reasonable cost to their customers. Gas utilities are commercial entities exposed to commodity risks, most especially the price of natural gas commodities. In addition to their physical transaction activities, many gas utilities use a variety of financial tools such as futures and financial derivatives or "swaps" to hedge against volatility in natural gas commodity costs. In general, gas utilities forecast the anticipated demand on their systems and assess the underlying physical exposure associated with that demand. Many gas utilities then determine if financial instruments are appropriate to mitigate all or a portion of that exposure. Some gas utilities are required by state regulatory agencies to hedge a portion of forecasted demand to manage potential price volatility. These activities are not speculative in nature; rather, gas utilities enter

into financial transactions to hedge or mitigate commercial risk associated with forecasted demand. As such, the financial transactions of gas utilities pose little or no systemic risk to the financial markets.

End-User Issues with CFTC Implementation of the Dodd-Frank Act

As noted above, regulatory certainty is essential for business planning and compliance. To illustrate the difficulty energy end-users like gas utilities have encountered in preparing to comply with the CFTC's regulations implementing the Dodd-Frank Act, let me use the agency's definition of a "swap" as an example. At the outset, it is important to note that the entire foundation of the CFTC's regulation of the financial derivatives market rests on what is or is not considered a "swap." Who is or is not a swap dealer or major swap participant, what transactions are required to be cleared, what transactions are required to be reported, what transactions are subject to position limits, *etc.,* all rest on the definition of a "swap." Many parties, including AGA, initially suggested that the CFTC define "swap" at the beginning of its implementation of the Dodd-Frank Act, so that market participants would have a clear understanding of the scope of the regulations as the whole regulatory framework was being developed. Instead, the CFTC did not issue a final rule defining "swap" until August 2012, more than 2 years after the Act was passed, and issued only an "interim" final rule at that. Even now, toward the end of its process, the CFTC has yet to define the parameters of its "swap" definition in a manner that can be clearly and consistently applied within the gas industry.

To give you a better sense of what is at stake, let me walk through the development of the "swap" definition as it relates to natural gas market participants. In August 2010, the CFTC issued an Advance Notice of Proposed Rulemaking,[1] requesting public comment on the key definitions that would be used to establish the framework for regulating swaps. The proposal did little more than reference the statutory definition of "swap," providing no views on what the agency considered the scope of the definition to be. After a round of public comment, in May 2011, the CFTC issued a Proposed Rule and Proposed Interpretations regarding the "swap" definition.[2] There, the CFTC proposed to exclude forward contracts in non-financial commodities from the definition of a "swap" under the Dodd-Frank Act, consistent with its historical interpretation of the forward contract exclusion under the Commodity Exchange Act. The CFTC explained that forward contracts with respect to non-financial commodities were commercial merchandising transactions where the primary purpose is to transfer ownership of the commodity and not to transfer solely the price risk. The CFTC noted that it had previously established an Energy Exemption for certain types of transactions that were not considered futures. The CFTC then proposed an interpretation to withdraw as unnecessary this Energy Exemption.

The CFTC believed that the statutory definition of "swap" explicitly provided that commodity options are "swaps." Thus, for non-financial commodity options embedded in forward contracts, the CFTC established a three-part test. The CFTC explained that a transaction will be considered an excluded forward contract (and not a swap) where the non-financial embedded option: (1) may be used to adjust the forward contract price, but does not undermine the overall nature of the contract as a forward contract; (2) does not target the delivery term, so that the predominant feature of the contract is actual delivery; and (3) cannot be severed and marketed separately from the overall forward contract in which it is embedded. The CFTC added that conversely, where the embedded option renders delivery optional, the predominant feature of the contract cannot be actual delivery, and the embedded option to not deliver precludes treatment of the contract as a forward contract. The CFTC then sought public comment on all aspects of its proposed definitions and interpretations.

The CFTC's proposed rule generated considerable confusion in the natural gas industry as market participants began to wonder whether their commercial merchandising transactions, particularly those with flexible delivery terms, would be considered "swaps" under the CFTC's proposed interpretation. Numerous comments were filed seeking clarification as to whether particular types of transactions would be considered "swaps." AGA, for its part, filed comments explaining that gas utilities enter into physical gas supply transactions with flexible delivery terms as important elements of their ability to meet their customers' needs at a reasonable cost. Be-

[1] *Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act,* 75 FED. REG. 51429 (Aug. 20, 2010).

[2] *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement,"; "Mixed Swaps; Security-Based Swap Agreement record-keeping,"* 76 FED. REG. 29818 (May 23, 2011).

cause gas consumption to residential and commercial customers is largely weather-driven (consumption increases as the weather gets colder) and predicting the weather is not an exact science, gas supply contracts with delivery flexibility help AGA members make sure gas supplies are, or can be made, available when the customers actually need the gas without having to pay excessively higher prices at the actual time of need and/or other fees associated with pipeline imbalance penalties.

In August 2012, almost 2 years later, the CFTC issued an interim final rule, further interpretations, and a request for comment on the interpretations.[3] The CFTC provided additional guidance on the scope of its forward contract exclusion. In particular, the CFTC established a seven-part test that it would apply in determining whether a contract with flexible delivery terms would be regulated as a "swap" or excluded as a forward contract. The CFTC then provided further interpretations responding to the requests to clarify whether certain types of transactions would be considered, and regulated as, "swaps." Notably, the CFTC sought to clarify that certain physical commercial transactions for natural gas pipeline transportation and storage service agreements would not be considered options, and thus would not be regulated as "swaps," if they met a three-part test. However, the CFTC added that if such transportation and storage agreements employed a certain two-part rate structure, such agreements would be considered options subject to swap regulation. The CFTC then believed that these interpretations would benefit from further public input and requested additional comments.

More confusion reigned. Was the rule final or only interim? How should the seven-part test be applied? What do some of the elements mean? Did the CFTC really intend to regulate as "swaps" all natural gas pipeline transportation and storage agreements with two-part rates? Again, numerous comments were filed seeking clarification of the CFTC's rules and interpretations. Many comments focused on whether pipeline transportation and storage agreements, long regulated exclusively by the Federal Energy Regulatory Commission (FERC) under the Natural Gas Act, would be considered options and subject to the CFTC's swap regulations. In November 2012, the CFTC's Office of General Counsel (OGC) issued a Response to Frequently Asked Questions Regarding Certain Physical Commercial Agreements for the Supply and Consumption of Energy. In essence, OGC staff stated that if a pipeline transportation or storage agreement with a two-part rate structure met an additional five-part test, the transaction would not be considered an option and thus not subject to regulation as a "swap." Apart from this staff action aimed solely at clarifying the two-part rate issue for pipeline transportation and storage contracts, the CFTC has not acted on the comments it received in response to its request for further public input on the "swap" definition and interpretations.

Relatedly, in April 2012, the CFTC issued an interim final rule holding that certain commodity options would be considered "trade options" if they met a three-part test. Trade options, while regulated by the CFTC, would not be subject to the full panoply of regulations established for "swaps." Notably, trade options would be subject to significantly less intense reporting requirements for counterparties that are not already required to report their swaps. Once again, several comments were filed in response to the interim final rule, yet the CFTC has not issued any further interpretations or clarifications regarding trade options, although the CFTC's staff has issued no-action relief regarding trade option reporting.

In the absence of clear guidance from the CFTC, numerous parties, including AGA, have filed requests for interpretive guidance and/or no-action relief from CFTC staff as deadlines for reporting and other compliance obligations have approached. Many of these requests remain outstanding and have not been acted upon by the CFTC or its staff.

Where does that leave us? There remain disagreements and confusion within the natural gas industry as to which types of gas supply transactions, if any, will be subject to CFTC regulation. These transactions are normal commercial merchandising transactions that parties use to buy and sell natural gas for ultimate delivery to end-use customers. They would not normally be considered speculative, financial transactions as the parties contemplate physical delivery of the commodity. Nevertheless, transactions that contain some option or choice for one or the other counterparty, raise questions for some as to whether they would be considered commodity options regulated as swaps, meet a three part test and a seven-part test to be excluded as options embedded in forward contracts, be viewed as trade options subject to a lessened reporting burden, or be considered facility use agreements that meet a three-part test and then a five-part test and not subject to regulation at all.

[3] *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; "Mixed Swaps"; "Security-Based Swap Agreement record-keeping,"* 77 FED. REG. 48208 (Aug. 13, 2012).

Some counterparties in the industry have taken the view that regardless of whether a transaction would satisfy the seven-part test for options embedded in forward contracts, they will report all such transactions as trade options out of an abundance of caution to avoid the risk of a violation of the CFTC's rules. Other counterparties have insisted upon contract provisions to force agreement as to the regulatory treatment of the transaction. Some AGA member companies, in the normal course of business, have entered into routine transactions with multiple counterparties where the different counterparties have conflicting regulatory interpretations of what are essentially identical contracts. Thus, normal contracting practices in the natural gas industry have been seriously disrupted.

Until the CFTC provides definitive rules clarifying the regulatory treatment of these transactions, turmoil in the industry will continue. Moreover, the different interpretations and understandings of the CFTC's scope of the "swap" definition is, and will continue to, lead to inconsistent reporting of swap transactions to swap data repositories and to the CFTC.

Administrative Process Reforms

AGA and its members have been frustrated in their efforts to obtain regulatory certainty from the CFTC in its implementation of the Dodd-Frank Act. Uncertainty with regard to something so fundamental to derivatives regulation as what is and what is not a "swap," is hampering business planning and compliance and disrupting contracting practices in the industry. It also hampers the CFTC's ability to be an effective market monitor and regulator. AGA believes that the CFTC and the industry would benefit greatly from additional administrative processes whereby industry participants could obtain in a timely manner the kind of regulatory certainty they need for business planning and compliance, and could challenge agency action if necessary. In particular, we offer the following recommendations:

First, AGA recommends that Congress amend the Commodity Exchange Act (CEA) to provide clear and defined procedures for challenging CFTC rules and orders in court. Although the CEA currently contains provisions allowing for judicial review by a U.S. Court of Appeals of certain agency actions, the provisions are very limited and provide no defined avenue for challenging CFTC rules and orders generally. A broad judicial review provision allowing for the direct challenge of CFTC rules and orders would have both a rehabilitative effect on the current process and a prophylactic effect on future agency action. Specific judicial review provisions would allow interested parties to challenge particular agency actions that are unreasonable and hold the CFTC accountable for its decisions. In addition, judicial review would have an important prophylactic effect by requiring the agency to think through its decisions before they are made to ensure that they are sustainable in court, thus enabling the agency to be a more conscientious and prudent regulator. In the absence of specific judicial review provisions, the general review provisions of the Administrative Procedure Act (APA) would apply, requiring parties seeking to challenge CFTC rules to file a claim before a U.S. District Court, move for summary judgment (as a hearing would likely be unnecessary), obtain a ruling and then, if necessary, seek further judicial review before a U.S. Court of Appeals. In the recent litigation over the CFTC's position limits rule, which followed the review provisions of the APA, the CFTC's General Counsel acknowledged the efficiency and desirability of direct review by the U.S. Court of Appeals of agency rules, and stated that the agency would have no objection to such direct review assuming Congress were to authorize it.[4] Accordingly, provisions allowing for direct review by a U.S. Court of Appeals of rules and orders of the CFTC would enable both the industry and the agency to benefit from the administrative economy, procedural efficiency and certainty of having a dedicated forum in which agency decisions are reviewed.

Second, and relatedly, AGA recommends that Congress provide direct judicial review of jurisdictional disputes between the CFTC and the FERC. In the Dodd-Frank Act, Congress directed the two agencies to enter into a Memorandum of Understanding within 180 days of enactment of the legislation, in order to resolve conflicts concerning overlapping jurisdiction and to avoid, to the extent possible, conflicting or duplicative regulations.[5] More than 3 years has passed, and no such memo-

[4] See Motion of Respondent to Dismiss for Lack of Subject Matter Jurisdiction, Doc. #1350987 at pp. 2, 4, *International Swaps and Derivatives Ass'n et al.* v. *CFTC,* No. 11–1469 (D.C. Cir. 2012) (stating that "direct review in [the U.S. Court of Appeals] would serve the interests of judicial economy" and that "the Commission recognizes the benefits of direct appellate review in these circumstances and would have no objection to such review."); Reply of Respondent in Further Support of Motion to Dismiss, Doc. #1353103 at pp. 2 n. 1, *International Swaps and Derivatives Ass'n et al.* v. *CFTC,* No. 11–1469 (D.C. Cir. 2012).

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. No. 111–203, § 720 (2010).

randum has been negotiated by the two agencies. For energy end-users such as AGA's member gas utilities, the main source of frustration with the CFTC's implementation of the Dodd-Frank Act has been the lack of regulatory certainty as to whether physical transactions traditionally regulated by FERC would now be subject to CFTC regulation as "swaps." Industry participants would benefit greatly by clearly defined scopes of jurisdiction as between the two agencies. Congress has already provided mechanisms for the judicial review of disputes between the CFTC and the SEC regarding swaps and security-based swaps (Section 712(c))[6] and novel derivative products that may have elements of both securities and futures (Section 718).[7] We encourage Congress to provide similar mechanisms with regard to jurisdictional issues as between the CFTC and the FERC.

Third, AGA recommends that Congress require the CFTC to provide better administrative processes for interested parties to seek clarity and guidance on agency issues. Under current CFTC rules, there are insufficient avenues available for the public to obtain timely, definitive guidance in the form of final agency action, particularly as to the impacts of the CFTC's regulations on commercial end-users. As a result, parties have relied on staff action in the form of no-action or exemptive relief, interpretive guidance, and/or interpretations by the General Counsel to obtain necessary clarifications of the agency's rules. These avenues are less than satisfying in that they reflect only the views of staff and not those of the Commissioners themselves. The CFTC should provide commercial market participants with specified administrative processes in which to obtain definitive guidance from the agency on a timely basis.

AGA believes that the inclusion of administrative process reforms in the CFTC's governing statutes and rules would have a positive impact on the agency's ability to be a responsive and effective regulator. AGA would be pleased to provide the Committee with supplemental information on specific mechanisms to achieve these goals.

Thank you for your consideration of these comments.

The CHAIRMAN. Thank you, Mr. Soto. Mr. Guilford?

STATEMENT OF GENE A. GUILFORD, NATIONAL & REGIONAL POLICY COUNSEL, CONNECTICUT ENERGY MARKETERS ASSOCIATION, CROMWELL, CT; ON BEHALF OF COMMODITY MARKETS OVERSIGHT COALITION

Mr. GUILFORD. Honorable Chairman Conaway, Ranking Member Scott, and distinguished Members of the Subcommittee, 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 Commodity Futures Trading Commission and to address matters relating to the CFTC's authorities regulating the activities in the commodity markets and the impact of those activities on end-users.

The Commodity Market Oversight Coalition, CMOC, is a nonpartisan 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 gas station operators, airlines and others who rely on transparent, functional and stable commodity markets in which to hedge our operations for the mutual benefits 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 that 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 commodity markets, seek to

[6] Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. No. 111–203, § 712 (2010).

[7] Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. No. 111–203, § 718 (2010).

prevent fraud, manipulation and excessive speculation and preserve the interests of *bona fide* hedgers and American consumers. Since its inception in 2007, our coalition and its member organizations have delivered testimony and written Congressional leaders in support of many of the reforms in Dodd-Frank and in legislation prior to Dodd-Frank's enactment. And though while Dodd-Frank was indeed historic legislation, it was not perfect, and Title VII reforms in which we spent the majority of our time were no exception.

Even with its imperfections, one cannot say that Dodd-Frank was unnecessary or that that 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 trillion and $25 trillion. Today the derivatives markets notional value exceeds $600 trillion. But even in the early 1990s, there had been episodes of fraud, Bankers Trust, Procter & Gamble, Gibson Greeting Cards. Bankers Trust had defrauded some of its derivatives customers, and second, there was evidence of manipulation in the markets. Sumitomo Corporation had managed to manipulate the world market in copper in part using the over-the-counter derivatives markets to disguise its operation and fund them. Later and after the fact there were other incidents of market manipulation discovered involving Enron and the electricity markets, Amaranth and natural gas, BP and propane, and crude oil.

When accepting the John F. Kennedy Profiles of Courage Award in 2009, former CFTC chair, Brooksley Born, stated, "Special interest 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 gaps, we will be haunted by our failure for years to come."

We, too, express concerns about what Dodd-Frank has done in our markets and certainly what it has had for impacts on our companies and our customers. That, however, doesn't mean we should do nothing, but it does mean that there are things that we should address. And we look forward to working with the Committee in the following areas that we would recommend specific attention be given. Number one is manipulation and excessive speculation. The Subcommittee should examine the efficacy of the October 18, 2011, position limits rule. As we all know, the Federal court remanded that back to the agency last year because there was a conflict between two different parts of the statute with regard to whether or not position limits could be in effect immediately or whether position limits were subject to an appropriate and necessary clause. The Federal court remanded it back to the agency in order to go back and touchstone. We need to clarify that.

Number two, our index funds. The Subcommittee should inquire within the CFTC of its progress in implementing the recommendations of the bipartisan PSI staff report in addressing end-user concerns over index fund speculation.

High-frequency trading. We urge the Committee to investigate the role of high-frequency trading and other potentially harmful or disruptive new trends in commodity markets and determine wheth-

er or not additional CFTC authority is required to deal with the potential impacts of high-frequency trading.

Penalties. We believe the Subcommittee should consider extending the statute of limitations for the CFTC from its present 5 years to a minimum of 10 years for its investigations.

Bankruptcy protections. In light of MF Global and Peregrine, we recommend the Committee—we would like to work with the Committee rather on the extension of the Securities Investor Protection Act to clients.

The trade option exemption is one that impacts a number of our members because it has a limitation of a $10 million net worth requirement with a separate $1 million net worth requirement for *bona fide* hedgers, and frequently our companies are small enough so they fall below that threshold. We would like to see that changed so that we continue to have access to engage in trades.

The Energy and Environmental Markets Advisory Committee was created in 2008, yet it hasn't met since 2009. We think the CFTC would benefit greatly by the advice of those who were actually in the industry.

And with that, I would like to thank you for your time and attention and I would be happy to answer any questions you may have, Mr. Chairman.

[The prepared statement of Mr. Guilford follows:]

PREPARED STATEMENT OF GENE A. GUILFORD, NATIONAL & REGIONAL POLICY COUNSEL, CONNECTICUT ENERGY MARKETERS ASSOCIATION, CROMWELL, CT; ON BEHALF OF COMMODITY MARKETS OVERSIGHT COALITION

Honorable Chairman Conaway, Ranking Member Scott, 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 future of the Commodity Futures Trading Commission [CFTC] and to address matters relating to the CFTC's authorities regulating the activities in the commodity markets and the perspectives of end-users.

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, commodity-dependent industries and ordinary 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.

We continue to remind the Congress to 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?

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 anti-fraud 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,[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]

Just last week it was reported that the Federal Energy Regulatory Commission is in discussions with JP Morgan Chase regarding an alleged manipulation of electricity markets that could cost the bank $500 million.[6]

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.

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 led 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 fully transparent and free of manipulation, excessive speculation and other disruptive trading activity. We need markets with participants that are accountable for their actions 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***

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[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 cosponsors, including Reps. Chris Shays of Connecticut, Jeff Fortenberry of Nebraska and Todd Platts of Pennsylvania.

[2] Pub. L. 111–203.

[3] *http://www.hsgac.senate.gov//imo/media/doc/REPORTExcessiveSpeculationinthe NaturalGasMarket*.pdf

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

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

[6] *http://dealbook.nytimes.com/2013/07/17/jpmorgan-in-talks-to-settle-energy-manipulation-case-for-500-million/*.

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.

Excessive Speculation is defined as that which drives prices higher in apparent defiance of supply and demand fundamentals. We contend that recent events point to just such a dislocation in the energy commodity markets, as follows:

	2007	2012
Unemployment	4.6%	7.6%
U.S. crude oil consumption	20 mmbls @ day	18.5 mmbls @ day
U.S. domestic crude production	5 mmbls @ day	6.5 mmbls @ day
U.S. WTI crude oil price	$72 @ bbl	$94 @ bbl
U.S. gasoline consumption	9.3 mmbls @ day	8.7 mmbls @ day
U.S. gasoline prices [ave]	$2.84 @ gal	$3.68 @ gal

In just the last 4 weeks we have seen U.S. WTI prices increase from $94 @ bbl on the NYMEX [August contract] to over $108 @ bbl—adding $14 @ bbl. At the same time, we have seen U.S. RBOB gasoline on the NYMEX [August 2013 contract] increase from $2.67 @ gal to $3.13 @ gal, adding 46¢ @ gallon.

As America consumes 360 million gallons of gasoline a day, NYMEX driven RBOB contract increases of 46¢ @ gallon will cost Americans an additional $165 million per day, $1.1 billion per week, $4.6 billion per month.

These market activities are occurring while, according to our Department of Energy's Energy Information Agency, WTI crude stocks at Cushing, Oklahoma have been at their highest levels ever recorded. In addition, in 2012 the U.S. saw the largest increase in daily crude oil production since commercial production began in 1859. Between 2007 and 2012 we saw not only the extraordinary demand destruction of 1.5 mmbls of daily crude oil demand, but at the same time saw a 1.5 mmbls @ day of increased domestic crude oil production—a swing of 3 mmbls. Yet, WTI crude prices increased more than 30%.

Further, in 2011 the U.S. became a net exporter of refined distillates for the first time since 1948 and in 2012 became a net exporter of gasoline for the first time since 1960. RBOB gasoline contract increases of 46¢ @ gal are with the backdrop of having seen a domestic demand destruction of 600,000 bbls @ day.

October 2011 Position Limits Rule

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.**[7] 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 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**

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

Dodd-Frank Act position limits mandate to require the CFTC to establish class specific limits on speculation.[8] 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.

The U.S. Tax Code and Energy Market Speculation

Futures contracts, as prescribed by **26 U.S.C. § 1256** of the tax code, are taxed with a blended rate of long and short-term gains: 60% long-term capital gains and 40% short-term. Whether one agrees or disagrees with speculation being a factor in commodity markets, most should agree that we should examine why this activity is subsidized by the Tax Code. The Tax Code incentivizes speculation in commodities over speculation in any other market. Even more, speculation in commodities is a great way to guarantee a lower tax rate than the general income tax, when compared to any other profession in America.

In essence, ***the Tax Code promotes speculation in commodities markets, and it does so in several ways.*** People who are speculating in commodity future markets are inherently short-run, and care far more about the discount on the short term capital gains tax rate than they do the increased cost of long-term commodity ownership. Whereas a short-term equity speculator is taxed at the general income rate, a commodities/futures speculator is taxed at 23%. The consequences of this are two-fold: first, there is an economic incentive for speculators to ply their craft in commodities markets as opposed to equity markets, and second, speculators desire volatility in the short-run in order to maximize their capacity to make money, such that there is a serious misalignment of incentives between speculative market participants and the purpose of commodity markets. [commercial/*bona fide* hedgers *versus* non-commercial financial speculators]

Meanwhile, short-term transactions that result in realized gains in commodity markets are not done with the intention ever taking or giving delivery of the underlying goods themselves. Rather, these transactions are done for the purpose of realizing a gain off of changes in price. These transactions require inefficiencies between supplier and buyer PLUS volatility in order to generate a profit. In seeking volatility, such transactions promote yet further volatility. Because of this fact, volatility and market dislocations lead directly to more opportunities for speculative gains. Pushing such actors into commodity markets creates a situation where volatility becomes a self-fulfilling prophecy for the benefit of a significant portion of market participants, but a detriment to society at large.

In examining the authorities of the CFTC one might examine why one body of Federal law seems to encourage energy market speculation [the Tax Code] while another body of Federal law seems to discourage energy market speculation [Dodd-Frank].

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.*[9]

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**

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[8] 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.

[9] Link to the Senate PSI Wheat Report: http://bit.ly/WheatRpt (Accessed May 1, 2013). **Editor's note:** the referenced link goes through a third party server, the official Senate link is *http://www.hsgac.senate.gov/imo/media/doc/REPORTExcessiveSpecullationintheWheat MarketwoexhibitschartsJune2409.pdf.*

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 2 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." [10]

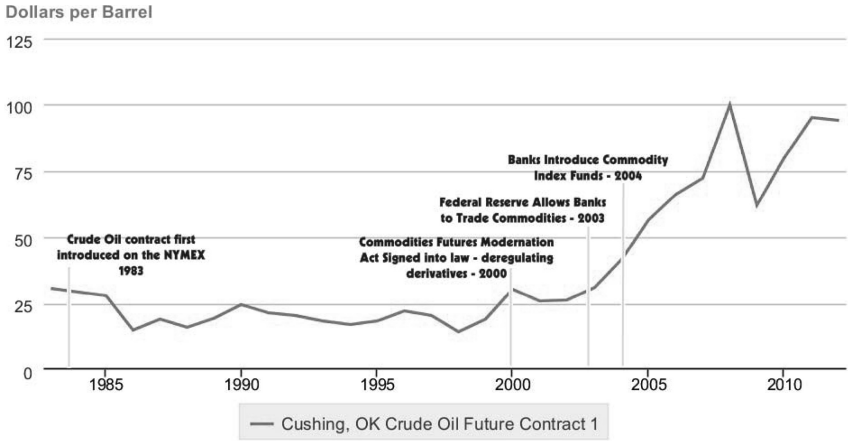
Had it not been for the unfortunate 2003 decision of the Federal Reserve that allowed regulated banks to trade in physical commodity markets, much of the artificial inflation of commodity prices we have seen since would not have occurred. Last week the Federal Reserve announced its intention to "review" its 2003 decision [11] and we encourage the Congress to make it known to the Fed that reversing that decision should be a priority at the earliest possible opportunity.

Figure One graphically illustrates the recent history of the energy commodity markets, deregulation, Federal Reserve decisions and then the results for energy prices when the investment banking community began to play a disproportionate role in those markets.

The Committee should consider proposals to limit the role of index funds in commodities.

Figure One

Cushing, OK Crude Oil Future Contract 1



Crude Oil price data from U.S. DOE/EIA.

[10] *http://www.altavest.com/education/default.aspx.*
[11] *http://www.federalreserve.gov/boarddocs/press/orders/2003/20031002/attachment.pdf.*

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 (nine 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.

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.[12] 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.[13] 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.[14]

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 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'

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

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

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

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."[15]

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.

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.[16] 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 minuscule fines just become part of the cost of doing business. Given this, **the Committee should increase fines and penalties as appropriate in order to more effectively deter manipulation and other unlawful behavior.**

Additionally, the CFTC is restrained by the blanket 5 year Statute of Limitations. This restricts the ability of Commissioners to prosecute violations of the CEA, including cases of fraud and manipulation. The existing 5 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.[17] 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 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 nonprofit 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

[15] June 12, 2013 *http://www.cnbc.com/id/100809395*.
[16] 7 U.S.C. § 13.
[17] Pub. L. 91–598.

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 nine 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 eight or nine 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, [**Redacted**], 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." [*http://www.tandfonline.com/doi/abs/10.1080/09614524.2011.562488*]

(2) Belke, Ansgar (IZA/University Duisburg-Essen)/Bordon, Ingo G. (University Duisburg-Essen)/Volz, Ulrich (German Development Institute) (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 as the imposition of tighter limits on speculative positions in food commodities—to prevent a further flow of liquidity into these markets." [*http://www.sciencedirect.com/science/article/pii/S0305750X12003038*]

(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." [*http://www.springerlink.com/content/41485582m36k3841/?MUD=MP*]

(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." [*http://www.sciencedirect.com/science/article/pii/S0301421511000590%20*]

(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." [*http://econpapers.repec.org/article/eblecbull/eb-12-00122.htm*]

(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." [*http://www.sciencedirect.com/science/article/pii/S014098831100017X%20*]

(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." [*http://www.sciencedirect.com/science/article/pii/S0140988311001228*]

(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." [*http://onlinelibrary.wiley.com/doi/10.1111/j.1477-9552.2010.00248.x/abstract*]

(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." [*http://erae.oxfordjournals.org/content/early/2012/06/27/erae.jbs017.short?rss=1%20*]

(10) Hache, Emmanuel/Lantz, Fréderic (IFPÉnergies 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." [*http://www.sciencedirect.com/science/article/pii/S0140988312002162*]

(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." [*http://www.sciencedirect.com/science/article/pii/S0140988309000243*]

(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 U.S. crude oil inventories since 2004; (2) repeated and extended breakdowns (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 affect crude oil prices." [*http://www.sciencedirect.com/science/article/pii/S0301421510007044*]

(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 nonagricultural commodities, especially copper and oil." [*http://www.tandfonline.com/doi/abs/10.1080/00220388.2011.649261*]

(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." [*http://rrp.sagepub.com/content/41/4/539.abstract*]

(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." [*http://www.tandfonline.com/doi/abs/10.1080/00220388.2011.649259*]

(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." [*http://www.sciencedirect.com/science/article/pii/S037842661200266X*]

(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." [*http://businessperspectives.org/journals_free/imfi/2010/imfi_en_2010_01_Sigl.pdf*]

(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." [*http://www.sciencedirect.com/science/article/pii/S1042443112001059*]

(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 the aggregate risk appetite for financial assets and the investment behavior of diversified commodity index investors." [*http://www.princeton.edu/~wxiong/papers/commodity.pdf*]

(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." [*http://www.sciencedirect.com/science/article/pii/S0301421511000590*]

(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." [*http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1979521*]

(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." [*http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2075579*]

(3) Algieri, Bernardina (Bonn University) (2013): *A Roller Coaster Ride: an empirical investigation of the main drivers 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 contracts on commodity markets, to profit from price fluctuations, is an important determinant of price dynamics." [*http://www.zef.de/fileadmin/webfiles/downloads/zef_dp/zef_dp_176.pdf*]

(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." [*http://www.afpc.tamu.edu/pubs/2/515/RR-08-01.pdf*]

(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." [*http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2010/07/21/000158349_20100721110120/Rendered/PDF/WPS5371.pdf*]

(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 creating 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." [*http://www.zukunftderernaehrung.org/images/stories/pdf/materialien.texte/whh_studie_bass_finanzmrkte_hungerverursacher.pdf*]

(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." [*http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2201600*]

(9) Basu, Parantap/Gavin, William T. (Federal Reserve Bank of St. Louis) (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." [*http://research.stlouisfed.org/publications/review/11/01/37-48Basu.pdf*]

(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." [*http://mpra.ub.uni-muenchen.de/37486/1/MPRA_paper_37486.pdf*]

(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." [*http://edocs.ub.unimaas.nl/loader/file.asp?ID=1709%20*]

(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." [*http://www.bancaditalia.it/pubblicazioni/econo/temidi/td12/td849_12/en_td849/en_tema_849.pdf*]

(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." [*http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1707103*]

(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." [*http://www.princeton.edu/~wxiong/papers/RiskConvection.pdf*]

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(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." [*http://www.nefiactioncenter.com/PDF/theriseofcommodityspeculation.pdf*]

(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." [*http://www.energiepolitik.de/oelpreisspekulation/*]

(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 3 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." [*http://www.consumerfed.org/pdfs/SpeculationReportOctober13.pdf*]

(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 . . ." [*http://www.dbresearch.com/servlet/reweb2.ReWEB?ColumnView=0&Function=showPeriOverview(NERESNOT;noTopic;noRegion)&Submit=ShowPdf&rwnode=DBR_INTERNET_EN-PROD$RSNN0000000000136534&rwobj=ReFIND.ReFindSearch.class&rwsite=DBR_INTERNET_EN-PROD& type=callFunction*]

(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." [*http://www.marketwire.com/press-release/oils-endless-bid-taming-unreliable-price-oil-secure-our-economy-dan-dicker-published-1503559.htm*]

(6) Goldman Sachs (2011): *Global Energy Weekly,* March 2011: "We estimate that each million barrels of net speculative length tends to add 8–10¢ to the price of a barrel of oil." [*http://www.energianews.com/newsletter/files/80e9ebe0ff67bd94432a4031ee17c2b9.pdf*]

(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." [*http://blogs.wsj.com/marketbeat/2008/10/10/the-official-demise-of-the-oil-bubble/*]

(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." [*http://blog.newconstructs.com/wp-content/uploads/2010/10/FrenkPaperReutingOECDStudy_IrwinAndSanders.pdf*]

(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." [*http://papers.ssrn.com/Sol3/papers.cfm?abstract_id=1945570*]

(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." [*http://www.nakedcapitalism.com/2008/10/commodities-continue-to-tank.html*]

(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." [*http://traderightuk.wordpress.com/2011/09/07/guest-blog-simon-hunt-on-copper/*]

(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 5 years has come from investment-related rather than trade-related business." [*http://www.reuters.com/article/2008/10/29/column-kemp-idUSLT9693720081029*]

(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." [*http://inefficientfrontiers.wordpress.com/2009/07/29/fundamental-misconceptions-in-the-speculation-debate/*]

(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." [*http://www.hedgefundintelligence.com/Article/3202027/AbsoluteReturn-Opinion/Investable-indices-are-distorting-commodities-and-futures.html?LS=Twitter*]

(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." [*http://www.eurodad.org/uploadedFiles/Whats_New/News/Speculation%20in%20Food%20commodity%20markets.pdf*]

(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 5 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." [*http://www.loe.org/images/content/080919/Act1.pdf*]

(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." [*http://accidentalhuntbrothers.com/wp-content/uploads/2008/11/probalytics-081117.pdf*]

(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." [*http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/hearing072809_petzel2.pdf*]

(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." [*http://www.stern.de/wirtschaft/news/maerkte/george-soros-we-are-in-the-midst-of-the-worst-financial-crisis-in-30-years-625954.html*]

(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." [*http://media.ft.com/cms/834d6096-de23-11df-9364-00144feabdc0.pdf*]

(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." [*http://ethanolrfa.org/page/-/ENTRIX%20Speculation%20Paper.pdf?nocdn=1&utm__medium=email&utm__campaign=New+Reports+Fault+Speculation+for+Volatile+Commodity+Food+Prices&utm__content=New+Reports+Fault+Speculation+for+Volatile+Commodity+Food+Prices+CID_284b92e095cb531b6481bde94e6c788a&utm__source=Email+marketing+software&utm__term=Cardno+Entrix*]

(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." [*http://harr123et.files.wordpress.com/2010/07/futureoffinance-chapter31.pdf*]

(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 . . ." [*http://www.minefe.gouw.fr/services/rap10/100211rapchevalier.pdf*]

(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." [*http://www.publications.parliament.uk/pa/cm201012/cmselect/cmsctech/726/72606.htm*]

(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." [*http://agriculture.gouv.fr/IMG/pdf/Nouveau_rapport_etape_Jouyet_Boissieu_Guillon.pdf*]

(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." [*http://www.theaahm.org/fileadmin/user_upload/aahm/docs/20102309_briefing_note_02_en.pdf*]

(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." [*http://uk.reuters.com/article/2009/06/30/iea-oil-idUKNWNA801920090630*]

(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." [*http://www.unctad.org/en/docs/tdr2009ch2_en.pdf*]

(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." [*http://www.unctad.org/en/docs/gds20091_en.pdf*]

(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." [*http://www.unctad.org/en/docs/gds20111_en.pdf*]

(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." [*http://www.un.org/ga/president/63/interactive/financialcrisis/PreliminaryReport210509.pdf*]

(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." [*http://www.fao.org/fileadmin/templates/est/COMM_MARKETS_MONITORING/Grains/Documents/FINAL_REPORT.pdf*]

(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." [*http://www.fao.org/docrep/013/am053e/am053e00.pdf*]

(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 noncommercial 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." [*http://www.fao.org/fileadmin/templates/est/Volatility/Interagency_Report_to_the_G20_on_Food_Price_Volatility.pdf*]

(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." [*http://hsgac.senate.gov/public/_files/REPORTExcessiveSpeculationintheNaturalGasMarket.pdf*]

(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." [*http://hsgac.senate.gov/public/_files/REPORTExcessiveSpecullationintheWheatMarketwoexhibitschartsJune2409.pdf*]

(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." [*http://www.hsgac.senate.gov/public/__files/SenatePrint10965MarketSpecReportFINAL.pdf*]

APPENDIX B

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

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.
[*http://journals.cambridge.org/action/displayAbstract?fromPage=online&aid=7077684&fulltextType=RA&fileId=S0022109009990421*]		
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."
[*http://www.bis.org/publ/mktc05.pdf*]		
Bichetti, Maystre, "The synchronized and longlasting 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 U.S. 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."
[*http://mpra.ub.uni-muenchen.de/37486/1/MPRA__paper__37486.pdf*]		
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."
[*http://papers.ssrn.com/sol3/papers.cfm?abstract__id=2022034*]		
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.
[*http://mesharpe.metapress.com/link.asp?target=contribution&id=HJV244322G246764*]		

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

Author(s), Title, Year	Data	Relevant findings
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.
[*http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1695041*]		
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 U.S. 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."
[*http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1958281*]		
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 . . ."
[*http://www.jstor.org/stable/10.1086/209666*]		
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.
[*http://www.sciencedirect.com/science/article/pii/S1042444X99000134*]		
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.
[*http://www.sciencedirect.com/science/article/pii/S0927538X00000238*]		
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.
[*http://onlinelibrary.wiley.com/doi/10.1002/fut.20393/abstract*]		

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."
[*http://fp7.portals.mbs.ac.uk/Portals/59/docs/MC%20deliverables/WP27%20A%20Golub%20paper%202_ReportMiniFlashCrash.pdf*]		
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."
[*http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2004231*]		
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.
[*https://www2.bc.edu/~taillard/Seminar_spring_2012_files/Hirschey.pdf*]		
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 systemwide transition from a mixed human-machine phase to a new all-machine phase characterized by frequent black swan events with ultrafast durations."
[*http://arxiv.org/ftp/arxiv/papers/1202/1202.1448.pdf*]		
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."
[*http://www.sec.gov/spotlight/sec-cftcjointcommittee/021811-report.pdf*]		
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.
[*http://www.kellogg.northwestern.edu/faculty/murphy_d/murphy_kim_spread.pdf*]		

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

Author(s), Title, Year	Data	Relevant findings
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, 2 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."
[*http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1686004*]		
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.
[*http://www.jstor.org/stable/30031860*]		
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 ultrafast speed creates the potential for periodic illiquidity"; in "regular market conditions," liquidity has improved and transaction costs are lower.
[*http://www.bis.gov.uk/assets/bispartners/foresight/docs/computer-trading/11-1276-the-future-of-computer-trading-in-financial-markets.pdf*]		
Locke, Sarajoti, "Interdealer Trading in Futures Markets" (2004)	U.S. futures, 1995	Unregulated or unconstrained market makers demand liquidity to manage inventories.
[*http://papers.ssrn.com/sol3/papers.cfm?abstract_id=265932*]		
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.
[*http://linkinghub.elsevier.com/retrieve/pii/S0022199696014717*]		
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."
[*http://www.nber.org/chapters/c11365.pdf*]		

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.
[*http://www.jstor.org/stable/2962316*]		
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.
[*http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.23.6354&rep=rep1&type=pdf*]		
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."
[*http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1924991*]		
Panayides, "Affirmative obligations and market making with inventory" (2007)	U.S. equities, 1991 and 2001	Mandatory market maker obligations reduce volatility.
[*http://www.sciencedirect.com/science/article/pii/S0304405X0700133X*]		
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, 2 minute inventory cycles.
[*http://www.jstor.org/stable/2327606*]		
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."
[*http://www.farmdoc.illinois.edu/irwin/archive/books/Futures-Regulatory/Futures-Regulatory_chapter2.pdf*]		
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.
[*http://www.sec.gov/news/studies/2010/marketevents-report.pdf*]		

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

Author(s), Title, Year	Data	Relevant findings
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.
[*http://www.newyorkfed.org/research/staff_reports/sr395.html*]		
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 highfrequency 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."
[*http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2021988*]		
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.
[*http://papers.ssrn.com/sol3/papers.cfm?abstract_id=881585*]		
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."
[*http://web.mit.edu/finlunch/Fall03/AlbertWang.pdf*]		
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 "highfrequency trading is positively correlated with stock price volatility."
[*http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1691679*]		
Zigrand, Cliff, Hendershott, "Financial stability and computer based trading" (2011)	Literature review and survey	Self-reinforcing feedback loops in computerbased 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.
[*http://www.bis.gov.uk/assets/bispartners/foresight/docs/computer-trading/11-1276-the-future-of-computer-trading-in-financial-markets.pdf*]		

The CHAIRMAN. All right. Thank you, sir. The chair would remind Members that they will be recognized for questioning in order of seniority for Members who were here at the start of the hearing. After that, Members will be recognized in order of arrival. I appreciate Members' understanding. We have six panel members. We will do a second round of questioning if possible, and I would ask the Members' indulgence that if you ask a question with precious little time on the clock, you are not going to get all six members of the panel to answer your question. So we will probably give you one panel member and then if that issue is important to you, you will stick around for a second round and go back to that point in time. So with that, I will recognize myself for 5 minutes.

Gentlemen, thank you for coming here today and presenting this to us. As I mentioned to a couple earlier, this is the detail phase of what we need to be doing. Most of the time Members of Congress in these hearings stick to the 10,000 foot level, but we need to get into the weeds with respect to this reauthorization, and if there are specific details with respect to the law itself, now is the time to get those in front of us as a part of that.

Mr. Cordes, regarding the proposed rules on residual interest and increased margin accounts for FCMs, I know the CFTC is relooking at that, but it seems to me that the SRO has done a pretty good job of setting up a daily confirmation process for cash balances, for segregated accounts. Is there additional regulation needed or would that be enough in this regard to protect and avoid forcing your members to put more money up and more money at risk, quite frankly, in those segregated accounts, or is the current SRO process adequate to protect in this regard?

Mr. CORDES. Thank you, Mr. Chairman. The current legislation that is put in place or I should say the rules that are there, currently today we have to track and report all of our segregated funds and report that in. But then it is also—the SRO has the ability to electronically look at where all those accounts are. So that is full transparency where that is today, and that is a big change from where it was probably about a year ago. They have access to real-time reporting on knowing what that balance is.

If the change on a residual interest doesn't come to be, probably what we are going to see is either the FCMs are going to have to put up additional capital on the balance sheet or more likely we are going to ask our customers to pre-fund their margin accounts additionally. It could increase their margin requirements by almost double if that happens.

The CHAIRMAN. I guess the question was, though, is that enough control already? Let me ask Mr. Monroe. Mr. Monroe, thank you for quantifying, specifically, an impact. One of the things that we do on the front end of these regulatory processes is predict bad things are going to happen, and it is hard to quantify. Now that we have something in place where you guys have experienced your costs actually increasing, being easily identified within the market as to who you were, was that a one-time occurrence, or you are seeing it regularly now?

Mr. MONROE. No, Mr. Chairman, that actually has continued to happen and in fact happened again in a trade that we did last week that was for a contract that would settle in 2014. So our con-

cern was these low liquidity areas of the market, 2015, 2016 and beyond, and we actually were identified in a 2014 trade.

The CHAIRMAN. And the $60 million that you mentioned, was that an annualized cost or was that on that one trade?

Mr. MONROE. No, that would be an annualized cost looking at the volume that we typically do in those illiquid areas that occurred.

The CHAIRMAN. All right. Can the regulatory scheme be such as to bifurcate the real-time reporting to where if you have a certain number, beyond a certain number of months on the contract it would fall under one set of rules, while near-term contracts fall under a different set? Is that too complex to regulate or what is the solution for your marked out out-month trades that you are being identified on?

Mr. MONROE. I think there really needs to be a liquidity test, and we are working with staff at the CFTC. And we have had numerous meetings with them on this issue, trying to get some interpretive guidance to come from CFTC on this issue. And we feel like there is a solution that recognizes that liquidity narrows as you go out on the curve, and it may be on an early month in something like jet fuel. And there is some public benefit or certainly public benefit in the early months where price discovery is critical. But out in 2017, there is no public benefit and in fact, we are basically handing inside information to nefarious folks.

The CHAIRMAN. I got you. Mr. Soto, with the time left, you mentioned judicial review of CFTC. Would you flesh that out a little bit for us?

Mr. SOTO. Currently the Commodity Exchange Act enables judicial review, direct judicial review, into U.S. Court of Appeals for very limited provisions, certain transactions and approvals. What we are seeking is a broad ability to go before a U.S. Court of Appeals for any rule-making or order issued by the Commission. At present you have to first go to Federal District Court, seek a summary judgment, and then appeal that to the U.S. Court of Appeals to get an answer on the rule-making, and that is a cumbersome and wasteful process.

The CHAIRMAN. All right. Thank you. Mr. Scott for 5 minutes?

Mr. DAVID SCOTT of Georgia. Thank you, Mr. Chairman. I would like to ask this question, get a response from each of you on the panel for this. It has been since 2008 since CFTC has had reauthorization, budget appropriations. That was before the financial crisis, that was before the Wall Street meltdown, before the derivatives regulations, increased responsibilities. But recently the House Appropriations Committee reported in an appropriations bill that reduced the funding of the CFTC by more than $10 million, even though Chairman Gensler warned in his testimony to the Committee that even at the current spending levels with sequestration, the Commission would face furloughs and staff losses.

So I would like to get each of you to respond to three questions, yes or no basically. Do you believe that the funds of the CFTC as proposed by the House Appropriations Committee are at an adequate level? Starting here, basically yes or no. The Chairman will knock me down if I don't get all these in in 5 minutes.

Mr. CORDES. I would say from our perspective we only see one piece of what they are doing. I think they could prioritize what they do. I am not sure if I know that is a yes or a no without having more details.

Mr. DAVID SCOTT of Georgia. Mr. Kotschwar?

Mr. KOTSCHWAR. I will give you the same answer as Mr. Cordes. Without more details, I can't tell you whether that is going to be enough or not.

Mr. MCMAHON. I would have to say the same. I really have not looked at the global issues around budget. So I can't give you a good answer to that. I apologize.

Mr. DAVID SCOTT of Georgia. But given the fact that the CFTC and much of your testimony, you are asking them to do more. They are faced with a budget crunch. They are losing staff, furloughs. They have Dodd-Frank Title VII to implement. You are there. Their workload has been increased by over 400 percent. Is that not enough information for you? Can we go on? Mr. Monroe, what do you think?

Mr. MONROE. I am not in a position to comment on that, either.

Mr. DAVID SCOTT of Georgia. Okay. Mr. Soto?

Mr. SOTO. Let me say I don't think the amount is as important as what the agency does with the funds that they are given. We hope that they would become a more effective and responsive regulator with the funds that they have.

Mr. DAVID SCOTT of Georgia. Mr. Guilford?

Mr. GUILFORD. Thank you for the question. CFTC staff today is approximately nine percent larger than it was 20 years ago, even though the notional value of the derivatives market over which it has jurisdiction has increased by over 30 times.

Mr. DAVID SCOTT of Georgia. But could you give me a yes or no?

Mr. GUILFORD. And the question was, is the House Appropriations mark sufficient——

Mr. DAVID SCOTT of Georgia. Yes.

Mr. GUILFORD.—in order to fund the agency? The answer is no.

Mr. DAVID SCOTT of Georgia. Good. Okay. Now, second, do you believe that the reduced funding that they have from the Appropriations Committee hurts the Commission's ability to listen, to evaluate and to do all the matters, to regulate, to give guidance on all of the range that they are doing regarding its rule-making? Yes or no.

Mr. GUILFORD. And even in some instances not being able to hire experts in order to carry out its responsibilities.

Mr. DAVID SCOTT of Georgia. Precisely. Thank you. Yes or no?

Mr. SOTO. Again, it is what they do with the money that they have, and we hope they become more efficient.

Mr. DAVID SCOTT of Georgia. All right. Yes?

Mr. MONROE. I would echo Mr. Soto on that.

Mr. DAVID SCOTT of Georgia. Same thing?

Mr. MCMAHON. We have always been able to meet with the staff and Commissioners and had no issue with difficulty there.

Mr. DAVID SCOTT of Georgia. Yes, sir?

Mr. KOTSCHWAR. I would echo that response. We don't have any trouble getting audience with the Commission when we need to, and also point out that——

Mr. DAVID SCOTT of Georgia. All right.

Mr. KOTSCHWAR.—House Appropriations reported level is one step in the process. That isn't the amount that is actually going to be ultimately decided on.

Mr. DAVID SCOTT of Georgia. Even with an increase in the workload? Yes, sir, your point, Mr. Cordes, on that question?

Mr. CORDES. I would say from our perspective the part of the industry we operate in and, I mean, we have had access to what we need. I would say it is a matter of what you do with those resources, how you prioritize.

Mr. DAVID SCOTT of Georgia. All right, finally my final point on yes or no here is do you believe, given the agency's responsibilities are growing, that they need resources in an amount that is greater than the $205 million it received in 2013? In other words, do you think they need more money to cut the furloughs, to do the staff, to be able to listen, to be able to do the job that they need to do with the increased workload that they have in this very complex area?

Mr. CORDES. Once again, I am not an expert in knowing what that whole budget is. I would just say look at what the priorities are.

Mr. DAVID SCOTT of Georgia. All right. Mr.——

Mr. KOTSCHWAR. I would echo that response, but I want to go just one level deeper. One thing you said earlier is that you heard a lot of testimony today about us asking them to do more. I actually—we have a lot of areas where we would like them to do less. We believe Dodd-Frank was about swaps regulation, and they are creating a lot of solutions that are in search of problems in the futures space. We think that they could do some prioritizing.

Mr. DAVID SCOTT of Georgia. Go right down very quickly, please, yes or no.

Mr. MCMAHON. From the end-user perspective, I think we would hope for less regulation of the end-user side.

Mr. DAVID SCOTT of Georgia. Okay.

Mr. MONROE. I think we are fine with——

Mr. DAVID SCOTT of Georgia. All right. Mr. Guilford? I mean, Mr. Soto?

Mr. SOTO. Commissioner O'Malia yesterday talked about information resources that he needs. Our point is that the data that is being developed right now, given the uncertainty in the market, is inconsistent, it is incomplete. So those technology resources are not——

Mr. DAVID SCOTT of Georgia. Thank you.

Mr. SOTO.—put to the most effective use, given where the regulatory regime is right now.

Mr. DAVID SCOTT of Georgia. I just want to know if you think they need to get more money to hire the staff that they need to do the job.

Mr. SOTO. If they got more money——

Mr. DAVID SCOTT of Georgia. That is all.

Mr. SOTO.—the data there is incomplete and inconsistent, and it would be wasteful.

Mr. DAVID SCOTT of Georgia. Mr. Guilford? Thank you, Mr. Chairman.

Mr. GUILFORD. Yes.

Mr. DAVID SCOTT of Georgia. Thank you so much. I got one yes.

The CHAIRMAN. The gentleman yields back. Mr. Austin Scott.

Mr. AUSTIN SCOTT of Georgia. Thank you, Mr. Chairman.

The CHAIRMAN. Five minutes.

Mr. AUSTIN SCOTT of Georgia. Gentlemen, thank you for being here today and helping us with this issue. I actually majored in risk management and have my Series 7, so I feel some of your pain. And I listened yesterday as the gentleman with the CFTC talked about their difficulty and even getting to a common definition with the SEC over the word *person.* And it seems to me that when we have two regulatory agencies essentially regulating the same field, that when they can't agree on what the definition of the word *person* is, then we are creating a situation where you may be in compliance with one regulatory agency and out of compliance of another, and it simply depends on which one may be auditing you at the time as to whether or not you are in compliance or out of compliance.

You talked about pricing. Most of you talked about pricing, and you talked about compliance and I know, Mr. Monroe, you talked about the $60 million in additional costs. I assume that that cost will either be reflected on your bottom line as a reduction in profits or it will be reflected in the price of a ticket to travel on Southwest Airlines. And that is one of the things that I think sometimes gets lost in this debate as we talk about complex financial issues is that the more we raise the cost to the end-user, and in my situation, I am talking about farmers in particular, you increase the cost to the grain farmer, the price, the cost is born by the person every time they buy a box of cereal. In the end it goes down to the consumer that purchases the last product.

So Mr. Cordes, you outlined some of the costs that are being incurred by end-users in complying with the new Dodd-Frank Act. Could you be more specific in some of the measures that the co-ops generally are having to take to address the new rules?

Mr. CORDES. Yes. Thank you, Congressman. In our particular situation, I am just talking for our license FCM group, we have a staff of roughly about 40 individuals. We have had one person that has been primarily on compliance. We have now ramped that up where it is taking two body full equivalents to do those kind of things, so it is those areas. It has increased compliance around record-keeping, record retention, auditing amongst our individuals, training, that kind of thing. I would also say though that under Dodd-Frank now, it has even rolled out further into the parent company, into the cash and physical transactions. We are now having to build out a full compliance group that not only looks at all the other compliance issues but now things that spill over from Dodd-Frank that start to affect the end-user that normally they would look at as normal transactions and commerce around cash and physical transactions are wondering, does this fit into the scope of new regulation.

Mr. AUSTIN SCOTT of Georgia. And would you agree that that increased cost in the end is born by the consumer that purchases the product?

Mr. CORDES. Yes, ultimately in the end as the market equalizes itself out, those costs will be passed on at some point.

Mr. AUSTIN SCOTT of Georgia. Mr. Soto, you are in the energy business, is that correct?

Mr. SOTO. Yes.

Mr. AUSTIN SCOTT of Georgia. And the cost of energy is reflected in everything we purchase in this country. The cost of manufacturing, energy costs being too high, can send manufacturing jobs overseas and the cost of transporting a product. Virtually everything that we purchase at some point or another gets to the store by a truck. So the cost of that energy is obviously reflected in the price.

Could you speak to the potential increase in costs to the energy consumer with the increased rules and regulations based on the end-users in your industry?

Mr. SOTO. Thank you, Congressman. To be honest, many factors can affect the price of natural gas. Right now natural gas consumers are enjoying the benefits of tremendously abundant natural gas resources in this country that is producing relatively low and stable natural gas prices for consumers. But having said that, and the concern that I would raise is that through the increased transaction costs associated with the hedging programs, the resources that utilities have to develop to manage these hedging costs, that all makes it more expensive to manage the price volatility for consumers, and that gets passed on to consumers. But more importantly, the wholesale natural gas market in this country has been tremendously competitive, innovative, creative, all redounding to the benefit of the customers, prices of the last decade notwithstanding, it is really a treasure of this nation. And the problem that I would see is if that market becomes less efficient, less competitive, because the transacting parties are concerned that their physical transaction might be considered a swap, we lose something tremendously.

Mr. AUSTIN SCOTT of Georgia. Mr. Chairman, I am out of time, but gentlemen, thank you for your testimony.

The CHAIRMAN. The gentleman yields back. Thank you. Mrs. Negrete McLeod? Mr. Gallego for 5 minutes.

Mr. GALLEGO. Thank you. With respect to the issue of what is or is not in a price, is there a way to break that down? I mean, as you indicated, Mr. Soto, there are a number of factors that go into any particular price. I am sure that is true in any industry, whether you are talking about giving somebody a raise, whether it is a line employee or whether it is an executive, the market prices for so many things. I mean, all that impacts—and ultimately the consumer pays for all of that, is that not accurate?

Mr. SOTO. That is correct, and if there are fewer counterparties willing to trade and if the markets become less liquid, the product offerings are less innovative, less creative, then that just costs more to the consumer.

Mr. GALLEGO. I am curious though as to in terms of—is there way to allocate costs per factor? I mean, you decided to give people X rate of return on their investment, so that is passed on or you decided to, or the price of one thing or another. I am just talking about the industry. I mean, for the airlines, it would be the same.

I mean every cost—ultimately, as a businessman, I mean, I was in the restaurant business. My family was in the restaurant business for a long time, and ultimately your costs are always passed on. I mean, when the price of any of the food that you are serving goes up, that price is ultimately reflected on the prices on your menu.

Mr. SOTO. The transaction costs associated with the uncertainty in the contracting market, that is probably more easy to quantify and to track. The impacts of illiquidity and the less innovative product offerings, that is probably much more difficult to quantify.

Mr. GALLEGO. So in terms of whether there are more rules and regulations or those kinds of things, is there a way to allocate how much that is costing you? Do the industries specifically break that down by that particular—is there a code? I mean, in government apparently everybody talks about it has to be coded right. Is there a code for this, because of these rules we have to code this differently and so we can track how much the cost is?

Mr. SOTO. We have not made that analysis, no.

Mr. GALLEGO. Do any of you do that? Can any of you break that down, any of the industries, break that down and code it differently so you can tell what is allocated to any change in the regulations?

Mr. MONROE. I don't know that we necessarily code an expense in a certain way because of an additional regulation, but I would say as I spoke to in my testimony that we view it as enterprise risk management, and if the markets literally are taken away from us, then there is risk to the enterprise. Not to overstate that issue, but a fuel price spike has been the undoing——

Mr. GALLEGO. Right.

Mr. MONROE.—numerous airlines.

Mr. GALLEGO. Yes, right. So with respect to the issue of agencies, one of the interesting things to me is when an agency in limited—granted, it probably doesn't happen that often, but when there is a rule that either is repealed or is changed so that it becomes more efficient. I find it interesting, for example, that we always talk about how this stuff costs more and costs more and costs more, and it raises the price, but it doesn't necessarily ever lower prices. And I mean, I know in the restaurant business, as an example, that when the price of a staple went up and your price went up and then when people got used to paying the higher price and then the price went back down again, the lower price wasn't always necessarily reflected in your menu prices. And how do you balance that with respect to allocating, giving credit where credit is due? Is there an opportunity to do that, if they make good decisions? Yes, sir?

Mr. MCMAHON. Well, the utility industry is a little bit different than that. It is a cost-of-service industry. It is regulated at the retail level, and compliance costs are something that is part of rate. So that is passed through to customers.

Mr. GALLEGO. Right.

Mr. MCMAHON. We have not seen so far any example of the Dodd-Frank Act as actually——

Mr. GALLEGO. Lowering, right.

Mr. MCMAHON.—lower costs or seeing any of the costs lowered, and our hope going in was that the end-user exemption was going to be a relatively clean and broad exemption that would really re-

lieve us from a lot of the regulatory burden, but that is not the case. And there is a lot of uncertainty around things such as posting margin, for example. You know, utilities are very credit-worthy, and therefore, they don't, on many of their swaps, don't need to post margin. Having to do that would tie up a lot of capital, and there would be a lot of costs associated with that.

So that kind of uncertainty hasn't really been fully quantified yet, but ultimately those costs are born by the rate payers.

Mr. GALLEGO. Thank you.

Mr. MONROE. And I would just point out, we are particularly proud to pass through lower costs to our customers and in market shares. We are happy to do that.

Mr. GALLEGO. I fly it regularly, so absolutely.

Mr. MONROE. Thank you.

The CHAIRMAN. The gentleman's time has expired. Mr. Benishek, 5 minutes.

Mr. BENISHEK. Thank you, Mr. Chairman. Thank you all so much for coming here this morning. I am a surgeon so I don't pretend to have a lot of knowledge about the commodities market, but I am learning fast since I got on this Committee. But I have a couple of questions on some of the things here.

Mr. Cordes, can you explain to me more about these no-action letters that the CFTC puts out? And apparently there is some ambiguity if these letters have any basis in law and it may create uncertainty. Can you just go through that a little bit for me, please?

Mr. CORDES. Yes, the simplest way I can explain that for you, Congressman, is typically there are rules and regulations, and if you can state your case that it is economically not feasible or physically impossible to perform under those things, you can petition the CFTC and say here is the situation. Can we get some relief? And depending upon the situation, they might issue a no-action letter or they may not. If they do issue a no-action letter, then basically it is giving you relief from having to comply with that particular regulation in your situation.

Mr. BENISHEK. Does that ever get overturned then that you can have like a none other jeopardy once the deadline has been passed?

Mr. CORDES. I am not aware of that because typically the CFTC follows through with that, but in my testimony I gave the example around this phone recording, and there are some issues there that we will be talking to the Commission about.

Mr. BENISHEK. Another question I have——

Mr. GUILFORD. Congressman? May I answer that question?

Mr. BENISHEK. Sure.

Mr. GUILFORD. Mr. O'Malia yesterday in his testimony said that there were just over 100 no-action letters currently issued by the CFTC in exactly the way the previous speaker just addressed. However, 24 of those have no expiration date. So our concern about those would be with regard to the fact that it isn't only a situation where the agency may not have fully formulated a policy with an issue, may not have finished a rule-making may not have extended rule-making far enough or collected enough public comment. But it is the extent to which the CFTC relies on no-action letters simply because it hasn't been able to complete its work.

Mr. BENISHEK. All right. I have another question about the record-keeping. I thought it was pretty amazing the way you described the fact that every message would have to be somehow documented and searchable and you have relied now on basically making phone calls to deal with this. Can you recommend some way for the CFTC to do this in a better way? I mean, obviously you have some pretty strong feelings about it.

Mr. KOTSCHWAR. Our recommendation would be let us not extend the notion of what needs to be recorded this far.

Mr. BENISHEK. What is the object of all that recording? What is——

Mr. KOTSCHWAR. I don't know what the object of that recording is. That is our point. We don't see any real good public policy value of recording.

Mr. BENISHEK. Is there value in oversight by collecting all that data? I mean, the way you described it: hundreds of transactions going on during a day and you have to maybe make a hedge position on some of your transactions. It seems like it is——

Mr. KOTSCHWAR. From a commercial perspective, we don't see any value in it. I mean, when we do a purchase or a sale with the producer or a customer, we do it with a contract, and we maintain all the records necessary to memorialize that transaction. And we don't feel the need to go as far as recording the phone call where we agreed with the farmer to buy his grain. That seems a little excessive. You know, we keep the records necessary for that. So going beyond that seems——

Mr. BENISHEK. Mr. Guilford, do you have a comment on that answer? I mean, I am trying to figure out why they have this requirement. Do you have an answer?

Mr. GUILFORD. I do, and if I could just follow on the previous answer I gave you just for a second. Three years ago we recommended to Congress that——

Mr. BENISHEK. Well, I would like to stay on the—I have only got a certain amount of time.

Mr. GUILFORD. Okay.

Mr. BENISHEK. So could you answer the question I asked you?

Mr. GUILFORD. Yes.

Mr. BENISHEK. What is your opinion?

Mr. GUILFORD. Of course. We worked a very long time in Title VII trying to draw distinctions between legitimate hedgers and non-legitimate hedgers, commercial *versus* non-commercial market participants. What we attempted to do in carrying out that work, Congressman, was to make sure, as much as we could, and we may not have been perfect in doing it, that all of the industries and more that are represented on this panel today——

Mr. BENISHEK. Well, I am trying to find out the value of the——

Mr. GUILFORD. I am getting to that.

Mr. BENISHEK. Getting. Yes, but I don't have much time.

Mr. GUILFORD. We had nothing to do with the financial crisis. So what the agency has done has cast a very wide net that encompasses everyone, even though we had nothing to do with the financial crisis, in an attempt to determine the extent to which there may be systemic risk or other threats posed to the financial system, none of which arised from the people you are looking at today.

So in point of fact, a lot of the information may not be useful.

Mr. BENISHEK. Unfortunately, you talked for about a minute but didn't answer the question.

Mr. NEUGEBAUER [presiding.] Gentlemen, we have been joined by the Ranking Member, Mr. Peterson. Mr. Maloney, you are recognized for 5 minutes.

Mr. MALONEY. Thank you. Thank you all. My question relates to the CFTC's $8 billion *de minimis* level. I would like to get your thoughts on that, to anyone who wants to answer.

Mr. MCMAHON. Well, when the *de minimis* level was established, the CFTC initially set it very low in their proposed rule. There were hundreds of comments sent into the CFTC, several oversight hearings and ultimately they settled on the $8 billion number. We felt that was a good number given the size of the market, and the fact from the energy perspective, we enter into oftentimes large volumetric trades. And so to hedge against some of the risks that we need to hedge on fuel and also on power supply, that isn't necessarily a very big number, even though it seems like a large number.

We are concerned that if it falls back to $3 billion without any kind of process associated with it, that would come at the wrong time because we are at a trough of the commodities cycle right now, and as Andrew mentioned, we are benefitting from low natural gas prices and the $2 to $3 per mmBtu range, for example. But we have seen in the last 4 or 5 years when it has been as high as $10 per mmBtu. So having that level set at an appropriate level high enough will ensure that end-users aren't pulled in and regulated as large banks as swap dealers. So that is why it was important.

Mr. MALONEY. Yes, thank you. And I am interested in hearing from the rest of the panel. But is it fair to say, Mr. McMahon, that you are comfortable then with the $8 billion level on an ongoing basis?

Mr. MCMAHON. We feel the $8 billion for now is a good level, and going forward it should be looked at in terms of where the overall commodity market is. But that is a good floor and a good level for where it should be.

Mr. MALONEY. Is there someone who disagrees with that? Would anyone like to comment on the—Mr. Guilford, I will give you an opportunity to comment on the idea of it dropping to $3 billion.

Mr. GUILFORD. I agree with the others on the panel who have said that it is a number that needs to be flexible with where the energy markets are. So a fixed number in time doesn't allow that to happen, and it can disadvantage us as competitors.

Mr. MALONEY. How would you best accomplish that, sir?

Mr. GUILFORD. That is a great question. You are going to have to give us a minute to think.

Mr. MALONEY. You and I are going to get along great. You just keep saying that. We are going to get along great. What would you prefer as a mechanism there? Would you leave it to——

Mr. GUILFORD. Well, the mechanism, as the previous speaker indicated, there have been times when energy markets have been very high with the $8 billion going to go up——

Mr. MALONEY. Well, right, it is not the same in all markets.

Mr. GUILFORD. Obviously it needs to be able to move with the markets. If it is a fixed number in time, then it is going to put us at a disadvantage unnecessarily so.

Mr. MALONEY. Correct, simply because the underlying commodity price.

Mr. GUILFORD. So we need to fashion a way to be able to allow that number to move along with energy markets. Now, I am not smart enough here today, Congressman, in order to give you an answer to exactly how we may be able to fashion a solution to that, but I am confident we can find one.

Mr. MALONEY. Got it. And in the 2 minutes I have remaining, I would like to give the panel an opportunity to comment on the definition of *bona fide hedging* and where it ended up. You touched on this, Mr. Guilford, so we can start with you if you want. Part of the problem here is that people don't understand that a certain level of speculation does create liquidity in the markets and is actually a very healthy thing. Obviously it is a Goldilocks problem, and I am curious whether those on the panel view excessive speculation currently as being damaging to the end-users and where you see that balance being struck.

Mr. GUILFORD. Well, 10 years ago when the markets were dominated 70 percent by legitimate market participants and 30 percent by speculation, we had far less difficulties than today where that has been flipped. Now it is about 70 percent speculation and 30 percent legitimate market participants.

So first, we share a concern with the rest of the panel with regard to the multiplicity of definitions of *bona fide hedgers*. That needs to be clarified, and we need to get all on the same page. Second, we do believe there is speculation in some cases and we would argue that those may have been evident in the past few years, damages our ability to be competitors in the marketplace and artificially inflates prices to consumers.

Mr. MALONEY. Mr. Soto?

Mr. SOTO. As the Commissioners mentioned yesterday, there are several definitions of the *bona fide hedge* exemption. We were fine with the definition as it was applied in the end-user exception. We were fine with it as part of the *major swap participant* definition. We have concerns about a much narrower definition as it applies to the position limits rule, and we think when the CFTC does come back on the position limits, they really need to fix that.

Mr. MONROE. I would just say that the markets seem to be running very efficiently now, and we are generally comfortable with what you are describing as a Goldilocks scenario. And we are always concerned about anything that threatens liquidity.

Mr. MCMAHON. From the utility perspective, again, we have large and oftentimes customized transactions. So this narrow enumerated list is very limiting.

Mr. MALONEY. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN [presiding.] The gentleman yields back. Thank you. Mr. Collins for 5 minutes.

Mr. COLLINS. Thank you, Mr. Chairman. I want to thank all of the participants today, and I am really interested in following up a little bit on the end-user exception, certainly to the clearing requirements, and I guess would ask each of you, is the definition

clear enough? You think it would be black and white if you are an end-user or you are not, are you finding situations where there is a gray area? How are you treating that gray area to know whether a particular company might be considered an end-user for the exceptions or not?

Mr. CORDES. I would say from our perspective, from NCFC is we are working with the Commission to get better clarity on that. I think we are getting much better facts on that. There is still some confusion out in the marketplace on how that should be treated on different swap dealers that you might work with to lay off some of that risk as an end-user. It has a ways to go, but we are getting better.

Mr. KOTSCHWAR. Ditto his answer. That is exactly where we are.

Mr. MCMAHON. I think Chairman Gensler described the Title VII and Dodd-Frank as a mosaic, and indeed it is. There are a lot of overlapping rules and requirements. It is very, very intricate, and our concern again on things such as the margin requirement, I mean one of the advantages of being an end-user is that you are exempt from margin, or you should be, but there is a possibility as to the way the rules interact that you could be subject to margin.

It is those sorts of issues that need to be clarified to make sure that it is a robust end-user exemption.

Mr. MONROE. Yes, I would echo that concern, and we also have a concern about being able to post non-cash collateral. We are unique in the fact that we post aircraft as collateral for our hedges. And so we want to be able to continue to do that as well, and that is potentially threatened.

Mr. SOTO. Same, from Richard and Mr. Monroe, that non-cash collateral, margin and capital requirements for uncleared swaps, that is something that not only the CFTC but the other Prudential Regulators need to work out.

Mr. GUILFORD. We currently don't have an issue with the *end-user* definition.

Mr. COLLINS. Thank you. Now, as you have moved forward and clearly you are looking for clarification from the CFTC, have any of you experienced the frustration of the no-action letters and are those shared amongst all of you where at least you are getting input from each other's questions?

Mr. CORDES. We have not requested one yet specifically for ourselves going through, so we will learn more of the process as we go along. I know they are public information after they are issued. How much collaborative effort going in up front, I am not aware of.

Mr. KOTSCHWAR. From CMC's perspective, we have asked for relief in several instances, but no, generally, overall it is very frustrating. We have a lot of final rules out there and a no-action letter is really basically an acknowledgment that no one can comply with the rule, either because of timelines or because of other substantive issues. So it is very hard to keep track of. You have the *Code of Federal Regulations* that says one thing, and then you have a stack of letters that tell you, never mind. But very difficult to keep on top of.

Mr. MCMAHON. I would agree that conflicting and overlapping issue is very important, and I would also say that in some cases,

for example, under inter-affiliate transactions, there are no action letters out there but sometimes the guidance is either insufficient or the facts don't line up exactly with the particular cases. So it is difficult.

Mr. MONROE. We have not had any experience with a no-action letter, but we have not found relief from this real-time reporting rule after several visits and lots of positive feedback, and yet we still have not seen any interpretive guidance that would fix that issue.

Mr. SOTO. There is a part of the agency's administrative process that really needs to be strengthened and that is the finalization of clear, definitive rules that the industry understands and how to comply with them. And that has to come at the Commissioner level, but there has to be final agency actions that everyone understands in the industry what their compliance obligations are. In the absence of that, we have no choice but to go to the staff and say don't enforce these rules that are uncertain in a way that we don't know how to comply with them. Working with staff has been, I mean, they have been helpful in trying to understand the industry concerns and providing the relief that they think is necessary, but it is indicative of a process where the Commissioners themselves are not making the decisions they need to make to give the industry certainty.

Mr. GUILFORD. We recommended to Congress 3 years ago that the Congress codify the process of the issuance of no-action letters. We recommend that to you again in this reauthorization process. I would be happy to work with you on that.

Mr. COLLINS. Well, thank you all for your comments. The time has run out. Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman yields back. Mr. Costa for 5 minutes.

Mr. COSTA. Thank you very much. Mr. Chairman, I have a number of questions specifically and generally. Let me begin quickly. Mr. McMahon and Mr. Kotschwar, in your testimony you talked about your concerns about the *de minimis* exemption on swap dealer registration. Do you envision more companies having to register under the current $8 billion level? Do you think that the current *de minimis* level of $8 billion is appropriate or do you think that Cargill and BP's dealing activity doesn't warrant registration or increased oversight?

Mr. MCMAHON. Well, I think from the utility perspective, as I said earlier, the $8 billion is appropriate, and that was recognizing, too, that that number was formulated when we were in the midst of a trough in the commodity cycle, very low commodity prices. That number should be a reflection of where the commodity prices are, where the overall scale and size of the derivatives and swaps market is, and we think the number is appropriate. If the number went down, yes, you would see, unintentionally, end-users who use these products to hedge commercial risk being pulled in and regulated like banks.

Mr. COSTA. And I don't know, Mr. Kotschwar, if you want to speak. Can you give us a sense how many more non-financial companies would have to register as swap dealers? As you may know, I was involved in that effort last year with public utilities in Cali-

fornia that were included under this and I felt was unfairly impacted. Can you comment?

Mr. KOTSCHWAR. And thank you for your efforts, Congressman. Yes, I think that we had not done sort of a sensitivity analysis looking at the different levels and how many companies would be brought in. But I can tell you that there are lots of examples where we are using swaps and commodities to hedge significant volumetric risk. For example, the provider of last resort obligation that many utilities have in competitive markets, and they need to hedge that risk in the event that it needs to be covered. You know, and these are large numbers. I think that setting it at an appropriate level, $8 billion is that level.

Mr. COSTA. And you also said in your testimony about amending the definition of *financial entity* or financial entities that are not inadvertently regulated. As we know, we have a number of financial institutions that can and often do own warehouses and other facilities. They store physical commodities. How would you talk about changing the definition in Dodd-Frank under that definitional category?

Mr. MCMAHON. Well, we want to make sure that commercial end-users or affiliates of commercial end-users are specifically excluded from that definition. In many cases because of codes of conduct and regulatory contracts, again, our industry is heavily regulated already at the Federal and state level——

Mr. COSTA. How do you do that relief without opening up a loophole that you can drive a Mack truck through?

Mr. MCMAHON. I think you just limit the exception to commercial end-users, those that are using these products to hedge commercial risk and specifically exclude banks, hedge funds and everybody of that ilk. So I mean that is what our argument is because oftentimes we have these subsidiaries set up within holding companies to do the financial trading for the rest of the family.

Mr. COSTA. Mr. Kotschwar, do you have any different comments about this quickly? Because I want to move onto another question.

Mr. KOTSCHWAR. Just to add a little bit to what he said about owning the stuff. You know, we acknowledge that the issue is out there, and it is something for the Prudential Regulators. The Federal Reserve it looking at it closely whether banks can own this stuff.

Mr. COSTA. Right.

Mr. KOTSCHWAR. But you know one of the things the CMC would observe is that regardless of what the Fed does in terms of allowing banks in or out of this stuff. If there is a demand for exposure to commodities, that demand——

Mr. COSTA. No, I have no doubt. The creativity of folks out there is boundless it seems to me——

Mr. KOTSCHWAR. Yes.

Mr. COSTA.—which is part of the problem. Mr. Guilford, your testimony comments about how the Federal Reserve is reportedly reconsidering its decision to allow banks to play heavily in the physical commodity markets. I mean, traditionally, we know what that role has been played. Can you expand on what role you think the banks may play in these markets?

Mr. GUILFORD. I don't think they should be allowed to play in these markets.

Mr. COSTA. At all?

Mr. GUILFORD. No, I don't.

Mr. COSTA. Okay. I am not so sure I don't agree with you. The whole panel, you may know, that Germany unilaterally imposed new rules over high-frequency traders including registration requirements. I hope you are aware of that. We are working with them on a host of efforts on a new trade deal on financial regulatory non-tariff area efforts. What are your thoughts about what the Commission should be doing in this area? They are looking at greater oversight on these traders. Should Congress include something about high-frequency traders? Quickly.

Mr. KOTSCHWAR. From CMC's perspective, I don't know that Congress needs to do anything about it. It is high-frequency trading. I think we need to make sure we distinguish between looking at the technology because technology is a good thing. It is the trading strategies. I mean, if you are not supposed to be able to spoof. If you are doing manual trading, you shouldn't be able to spoof, if you are electronically trading or high-frequency trading, either.

The CHAIRMAN. The gentleman's time has expired. Mr. Neugebauer for 5 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Thank you for having this important hearing. Mr. Monroe, you mentioned in your testimony that the specific trades you talked about where you were in the marketplace and market participants could have said, "Oh, Southwest is in the market today." Was that a one-time occurrence or has your DNA been kind of discovered out there so on a regular basis that people know that is a Southwest transaction and they are trying to hedge or——

Mr. MONROE. Yes. Well, thank you for that question, Congressman. Well, it happened the day—we had a trade the day before the database, the website came up, in a trade the day after. And the e-mails came and the phone calls came immediately. And then we were quiet for trading for a while. We don't trade every day. We are an end-user. We are hedging our risk. And then when we came back into the market again, we were discovered again.

So we have a specific footprint that we leave. We trade in high volume, we trade in certain ways and especially those who have traded with us before, and if we are not trading with them on that particular day, they know that that is us.

Mr. NEUGEBAUER. So you think the fact that that is occurring, is that negatively impacting Southwest Airlines do you think?

Mr. MONROE. Certainly it is a competitive issue. Typically we wouldn't have to disclose our hedging positions until the SEC required it at the end of a quarter, which is fine. But to have to have that reported the moment that it happens is a competitive issue, and then there is the concern about the actual swap price rising or the spread rising on us.

Mr. NEUGEBAUER. So is there anything that could be done to give you that anonymity that you need? I mean, what would be the fix for that?

Mr. MONROE. There is a liquidity test that is needed, and we feel like that liquidity test probably prescribes that the real-time re-

porting still continues, needs to be done to the public in the near close-end months where price discovery is important. But in these illiquid areas, the delay can be as much as 30 days. At least that 30 days gives our counterparty the opportunity to come out of those positions. And we do believe in real-time reporting to the CFTC. That should happen. It is just to the public. There is no public benefit to a 2017 crude oil trade being posted within 15 minutes.

Mr. NEUGEBAUER. So you are saying that those far out contracts really don't affect the near-term cash markets?

Mr. MONROE. Yes, and that is typically, just to your earlier question, that is typically where we are seen, where we are recognized as hedging. If I am hedging in the next few months, they wouldn't see me there. There is too much liquidity. It is where there is not enough liquidity and there is clearly a large animal in the room. That is us and they know it is us.

Mr. NEUGEBAUER. What would the disallowance of non-cash collateral as margin, how would that impact Southwest Airlines?

Mr. MONROE. Well, that would impact us very negatively. Again I mentioned earlier, we use aircraft for collateral, and that helps us to lower our cost of capital rather than to have to go out and borrow cash to post it as collateral. And we have billions of dollars' worth of unencumbered aircraft that we are very proud of, and we use those in these markets.

Mr. NEUGEBAUER. Thank you. I appreciate that. You know, one of the things I think that we keep hearing, and whether it is this panel of end-users or when I am in the 19th Congressional District of Texas, is that people that are using financial services, whether it is hedging or other financial services, with Dodd-Frank and CFTC rules and all of these things, is that it is creating a huge amount of uncertainty, and that uncertainty is playing out in how companies are conducting their businesses.

Mr. Cordes, would you say that that is impacting—I think about grain dealers or grain elevators in Texas. We may make it difficult where they just quit providing hedging opportunities. What would that do to the—where would their customers then go for that service?

Mr. CORDES. Yes, I can provide you a little bit of an example. If you think back to 2008 when the grain markets were moving quite a bit higher, we had increased margin requirements that come into the marketplace, started putting a lot of stress on the working capital that a lot of these grain dealers had. Some of them got stretched to the point where they just had to quit buying grain. They said I cannot physically handle this anymore. So what happens then is the farmer is faced with where is an outlet? I like these prices but how can I lock it in? One, they would have to start financing themselves to do that, or two, they would just have to wait. And we saw some of them waited. So there is some opportunity that is missed there.

So that furthers into today's discussion around some of these potential changes around residual interests. Some of these things, if we are going to increase the working capital needs, you are probably going to see some of these firms that will be stretched to the point where they are saying I can't continue to buy grain or maybe

I need to get out of business and merge with somebody else. So then it limits the choices that the farmer ultimately sees.

Mr. NEUGEBAUER. Thank you, sir. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired. Mr. Vargas for 5 minutes?

Mr. VARGAS. Thank you very much, Mr. Chairman. Again, thank you for the opportunity to ask some questions. I, too, would like to thank all the witnesses for being here. It sounded like some of you, that you listened to the testimony yesterday from the two Commissioners. So a question was asked of them in two different ways. What is the thing that keeps you up at night or what is the thing—and you can't say my 3 year old. That has been used. That was yours, that is true. But what is the thing that worries you the most? We would all agree with the primary goals of Dodd-Frank, protecting the financial system against systemic risk and increasing transparency in the derivatives market. But what is it that worries you the most? Yes, sir, Mr. Soto, since my mother's maiden name is Ms. Soto. Why don't we go to you first, sir?

Mr. SOTO. What worries my members is getting that phone call from CFTC enforcement staff that they have done something wrong, despite their best efforts in trying to comply with difficult-to-understand rules, they still, the staff, thinks that they have done something wrong. And I have seen Federal agencies, not the CFTC, penalize industry participants millions of dollars for misclassifying their transactions in a way that results in a reporting violation.

And so I mean, those concerns are real. So when they come to their association, their national trade association, and say what can be done, what keeps me up at night is how do I get a straight answer from the agency? How do I get a final rule that is well-defined, clearly sets out what the compliance obligation is so our members know how to do business planning and compliance? And that is the source of my frustration. That is what keeps me up at night.

Mr. VARGAS. Well, Mr. Kotschwar, in reviewing your comments, I think you were saying that it has become—some of these rules—let me see if I can find exactly. Given that we strongly believe that the CFTC's current trend toward very prescriptive changes is a bad thing. So you almost argue the other way, that there should be some flexibility, that compliance is very costly. But I mean, I have been trying to listen to understand because you want some clear rules, but at the same time, if it is too prescriptive, then the compliance costs go way up and compliance attorneys like you like that, but it is not a good thing necessarily for the system.

Mr. KOTSCHWAR. Well, certainty is a good thing, but you know, over-prescriptiveness is not a good thing, I guess. I don't know where the fine line is between certainty and being over-prescriptive. One of the things that CMC members worry about a lot is where certainty in this area of *bona fide* hedging. You have heard the testimony, a lot of different definitions of it. This is the one where we really see a situation of this is very ancillary to what Dodd-Frank was trying to do. You know, we are trying to set up a framework for swaps. What was going on in the hedging in the grain industry, in the electricity industry, that requires the regulator to come in and topple everything we know about *bona fide*

hedging on its head and start over? This is very destabilizing, and it worries us.

Mr. VARGAS. Anybody else? Mr. McMahon, sir?

Mr. MCMAHON. Yes, I would just add that I think not falling over one of the trip wires that would have you miscast as a swap dealer. I think that there is so much overlapping and interwovenness between these regulations that there is really a concern that inadvertently somehow you will hit one of these trip wires and be miscast as a dealer and regulated to the extent that banks are and ultimately, in order to avoid that, anecdotally we are hearing there are fewer counterparties in the market and companies are going more physical which, in a lot of cases, is a more costly way to hedge.

Mr. VARGAS. Mr. Cordes?

Mr. CORDES. I would say from our perspective what keeps us up at night is this potential one-size-fits-all. You have different sized firms. It used to be you had guidance from the CFTC. Now it is pretty much you must follow this path, this rule, the prescriptive down. So what gets us worried at night is, okay, what have we overlooked? What are we missing and what is it going to cost us to comply with doing all that stuff which in a lot of times a smaller firm, you have a much better view. You see a lot of the things. You don't have layers that things get missed. It is like we can do that guidance, but to go through all that other stuff just gets to be a lot of formality that just adds cost.

Mr. VARGAS. Thank you. Thank you, Mr. Chairman. I yield back. Thank you, sir.

The CHAIRMAN. The gentleman yields back. Mr. Hudson for 5 minutes.

Mr. HUDSON. Thank you, Mr. Chairman. I thank the witnesses for being here today.

Mr. McMahon, I enjoyed visiting with your folks last week and appreciate in your testimony where you discuss the implications of reducing the *de minimis* threshold with deliberate CFTC action. I am glad you raised this point because it is something I am very concerned about, something I am working with this Committee on.

As I talked to Commissioner O'Malia yesterday, I understand that the *de minimis* level is based on a notional value. From his testimony I gather that works for interest rates lops but in commodities markets, rising energy prices can push entities over the threshold by giving them changes in their trading. This seems like a real problem to me. How would you suggest the CFTC address this clearing problem?

Mr. MCMAHON. And thank you for all your support and efforts on behalf of the industry, Mr. Congressman. At the end of the day, our hope is that this level, to the extent that they go for a look-back, that there is a process put in place where all the stakeholders can come in. I think it should look at the overall scale and scope of the market but also recognize that it is a very volatile market, particularly with respect to our fuels. Historically it has been. Our hope is that it is a deliberative process. It involves rulemaking, that all the stakeholders have an opportunity to participate and obviously with the guidance and oversight of the Congressional committees. I think that is the best way to get a result that

will ultimately preclude commercial end-users, such as the folks represented on this panel, from being inadvertently being cast as swap dealers.

Mr. HUDSON. Thank you for that. You touched on this a little bit but has the CFTC's approach to rule-making and the resulting rules caused any of your members to restructure or reduce hedging, trade less officially? Could you maybe explain that in a little more detail?

Mr. MCMAHON. Thank you. Our industry is heavily regulated at both the state and Federal level. In some cases there are overlaps between the regulation. The Dodd-Frank Act did call for the FERC and the CFTC to put in place an MOU. That Memorandum of Understanding was really never put in place. I think that is an issue of some concern for our industry. But in many cases, one of the things that many of our companies are set up as holding companies, and in order to be efficient about how they trade and to separate the regulated businesses from the non-regulated businesses, they have trading entities within there and a real concern. We felt that that was an appropriate way to make sure that the overall entity would be able to maintain its end-user status since the purpose of that trading entity was to trade on behalf of the end-user. Because of this financial entity concern that I put in my statement, that is something that that end-user status could be lost from that advantage overall.

So I think that is an example of a real concern with the way that the rules are coming out, also the interaction between the other Prudential Regulators and the CFTC, and that is something that we hope can be resolved.

Mr. HUDSON. I appreciate that. Mr. Soto, in your position, your primary focus as I understand is to inform your members of the regulations they must adhere to and a system of staying between the lines, so to speak. Can you explain to the Committee why regulatory certainty is so critical to what you do and elaborate some more on specifically what that means for business planning?

Mr. SOTO. Thank you. Our industry, the natural gas industry, is heavily regulated. There are several Federal and state agencies that have some oversight over the actions and activities and operations of the utilities. So our members are used to compliance, and they build sophisticated programs to make sure that they understand each of the regulatory obligations, chart them out, make sure all their transactions and operations are consistent with those obligations. And the difficulty comes in if they don't understand what those obligations are requesting them, whether a particular transaction would be subject to a specific set of regulations or overlapping or conflicting regulations with another agency or whether a particular operation has to be done in a certain way. IT systems, resources have to be devoted in order to comply with record-keeping or reporting requirements. Whenever those regulations are unclear, those operations are disrupted.

And so we are hoping that, again, the theme that I have been trying to express today is the notion that we need to get answers from the agency in defining all of their regulatory obligations, very clearly, very definitively, from the Commissioners themselves and not necessarily from staff actions and no-action letters and inter-

pretive guidance. It has to be the agency through the process. We file comments, answer the comments. That is what we are really seeking.

Mr. HUDSON. Thank you, and Mr. Chairman, I yield back the seconds I owe you from yesterday.

The CHAIRMAN. All right. Let the record reflect that. I appreciate that. The gentleman yields back. Mr. Scott for a second round, 5 minutes.

Mr. DAVID SCOTT of Georgia. Thank you, Mr. Chairman. Mr. Guilford, let me go back to you. You know, in my opening statement I remarked about my concern about the banks purchasing these warehouses and holding onto these tons of aluminum and other commodities, oil takers, all that. Tell me why you feel, where is the danger there? What do we have to look forward to? And can you explain for us why your position is that this should not be?

Mr. GUILFORD. It is almost as though the country is being turned back about 100 years to the turn of the 20th century when Teddy Roosevelt first broke up the great trusts, and it is based on the very same reason, the concentration of power in one place of an entity that controls the physical market to an extent that it has the ability perhaps to manipulate prices. It takes vast positions in paper markets, so it is dealing with both sides of the energy marketplace, and at the very same time, it is selling us our fuel as a wholesale supplier. It has another division that is helping us hedge those purchases because we are literally tens of thousands of businesses whose responsibility it is to try to provide consistent and stable prices for consumers. And then on top of that, we can open an investment account and a 401(k) plan. It seems like it is becoming just an extraordinary concentration of power in one place, and we think that there may be great danger in that. And I think that is where we have to be very cautious. This didn't start until 2003.

I would only tell you, Mr. Scott, that most of these contracts went on the markets at the end of the 1970s and the beginning of the 1980s. We functioned for over 20 years without the financial services' industry's deep penetration into these markets. But since that has occurred, our concern has grown about the nature and extent to which we have distortions in the markets because of it.

Mr. DAVID SCOTT of Georgia. Do you see a threat to a possible crisis in any way, financial instability, inflated pricing or any of those things? Because it is clear from the ruling of the Federal Reserve that the banks are operating basically within the regulations they have, and they have up to 10 years to dispose of these ownerships.

Mr. GUILFORD. We are grateful for the fact the Federal Reserve is reviewing that decision with the potential toward it being overturned in September. And we would encourage the Congress to communicate with the Federal Reserve, the very important nature of their doing that and doing it thoroughly.

Mr. DAVID SCOTT of Georgia. You definitely see a danger to——

Mr. GUILFORD. Yes.

Mr. DAVID SCOTT of Georgia.—financial stability with that?

Mr. GUILFORD. Yes.

Mr. DAVID SCOTT of Georgia. All right. Now, back to the whole panel, I hope I get a better yes or no ratio here. And this is just

the basic yes or no. But some of my Republican friends—and I do have Republican friends. I work with them very closely. But they are both in the House and the Senate supporting legislation that totally would repeal Dodd-Frank. And with regard to Title VII of which we are all involved in in the commodities, the derivatives and so forth, do you agree with my Republican friends that it should be repealed entirely and that the regulation or lack thereof that existed prior to the law is the appropriate regulatory regime? Yes or no.

Mr. CORDES. That is a pretty full question. You know, certainly some of the new things that have come in around transparency have been helpful. There are some other things that have been hurtful. I am not sure I can give you a full answer on a full repeal or not.

Mr. DAVID SCOTT of Georgia. All right. Good. Yes, sir?

Mr. KOTSCHWAR. I think generally the CMC position on that would be no because the CMC was supportive of the goals of Dodd-Frank which was to bring swaps into a regulatory arena that was somewhat comparable to what existed for futures.

Mr. DAVID SCOTT of Georgia. So you don't support repeal? Yes, sir, Mr. McMahon?

Mr. MCMAHON. As I said in my statement, we support the goals of Dodd-Frank. We just need to get these issues correct.

Mr. DAVID SCOTT of Georgia. All right. Mr. Monroe?

Mr. MONROE. We would not.

Mr. DAVID SCOTT of Georgia. All right. Mr. Soto?

Mr. SOTO. I am here on behalf of my members, and my members have not told me one way or another whether they support repeal or not. So I can't give you a definitive yes or no answer. I am here to tell you we want the regulatory regime to be as clearly defined and understood as possible.

Mr. DAVID SCOTT of Georgia. All right. And Mr. Guilford?

Mr. GUILFORD. No, we are not in favor of total repeal.

Mr. DAVID SCOTT of Georgia. All right. Thank you very much, Mr. Chairman.

The CHAIRMAN. The gentleman yields back. Mr. LaMalfa for 5 minutes?

Mr. LAMALFA. Thank you, Mr. Chairman. Maybe I ought to ask, would you be in favor of partial repeal which kind of sounds like that because all or nothing is probably something you can't say or maybe completely before with a little more clarity probably being reasonable. So maybe I could just get you all to nod your heads yes or no. Would you like to see partial repeal? I am seeing some nods. Okay. All right.

We have some cleaning up to do, a lot of it, and I hear a lot of complaints in general about the far reach of the law. When some things went wrong with finance markets recently, some effort was needed. But as happens around here, we swing the pendulum not just a little bit, we swing it all the way.

So let me ask Mr. McMahon just a couple, following up on—you are probably aware of my bill, H.R. 1038. If that was put into law, having to deal with the threshold for swap dealers from $25 million to the $8 billion for taxpayer-owned utilities, if we don't get this, or if CFTC does not act in this manner as they alluded to at yester-

day's hearing, do you think the effect on rate-payers is going to be detrimental without this fix?

Mr. MCMAHON. Ultimately, utilities, our members, can go two different courses. I think that if the threshold for the *de minimis* level went down, you would find people not doing a lot of the hedging and the activities that would cause them to cross that threshold. So what that would mean at the end of the day, again, our goal is to deliver affordable, reliable, stable rates to our members. So what that would do is basically cause us to do less hedging which would probably cause more volatility in rates because of the inherent nature of the fuels and feed stocks that we use to generate electricity.

You would just see a movement toward more physical sites with transactions which can be extensive, and you would see a movement so that you wouldn't become regulated like a bank and a swap dealer. So we think this is very, very important to get this right because at the end of the day, there was a recognition that the activities that the companies and industries do on this table do not create systemic risk which was ultimately the objective of Title VII to address systemic risk and Dodd-Frank. And so we think that getting the level right is very important.

Mr. LAMALFA. You kind of answered my second follow-up and that is the whole thrust of our legislation is what did tax-payer owned utilities have to do with the financial crisis anyway? You know, so we think it was maybe an oversight or a little lack of common sense on that.

For Mr. Soto, I am interested in the problems we keep hearing about the no-action letters. Can you provide an example of a time that you really had to rely on the relief of a no-action letter or get regulation clarification from CFTC on that?

Mr. SOTO. As I described earlier today and in my testimony, there is uncertainty and confusion in the industry as to how certain gas supply transactions would be treated, whether they would be treated as exempted or excluded forward contracts, or whether they should be treated as trade options or whether they should be treated wholly as swaps. And part of that confusion was resolved a bit in the CFTC's proposed rule to treat trade options with a lesser regulatory reporting requirement. But as that reporting requirement deadline came nearer and nearer and people were still confused as to what transactions would be—could we report these as trade options or would they still be excluded? The CFTC granted no-action relief as to how to report trade options which gave the industry a little bit of a breathing room, knowing that in case they had to report these transactions, at least they could report them under a lower reporting burden as trade options. And so people breathed easier a little bit. But the fundamental question of what transaction is a swap, what transaction is excluded as a forward, what transaction is a trade option, that is still very unclear.

Mr. LAMALFA. And the last-minute nature of those clarifications made it probably even more difficult to——

Mr. SOTO. Indeed.

Mr. LAMALFA.—running down two different tracks, *et cetera.*

Mr. SOTO. I think the relief was granted within a week when the deadline came due.

Mr. LAMALFA. Yes. All right. I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman yields back. Mrs. Hartzler for 5 minutes.

Mrs. HARTZLER. Thank you, Mr. Chairman. Thank you, gentlemen, for being here today to let us know how the implementation of the Dodd-Frank is impacting each of you.

Earlier this year I introduced H.R. 2136, the Small Business Credit Availability Act, and that would exempt certain end-users such as farm credit lenders and nonprofit electric cooperatives from the *financial entity* definition in Dodd-Frank if their outward swaps exposure does not exceed $1 billion. And I have since worked with Representative Michael Grimm from New York to ensure a comparable exemption was included in his bill, H.R. 634 which passed overwhelmingly in the House earlier this summer, and that excludes these end-users from costly capital and margin requirements.

So I was wondering, Mr. McMahon, can you elaborate on the effects of including end-users like electric companies and rural electric cooperatives in the *financial entity* definition?

Mr. MCMAHON. Well, again, going back to the question, I think it would have a very detrimental effect of being classified as a financial entity because you would lose your end-user status. Even if one entity within a holding company was classified that way, they would not be able to trade on behalf of the regulated entity who is the end-user. So I think that would be very detrimental.

I think generally we have looked at this issue more broadly in terms of: if the end-user status was taken away and all of the swaps and derivatives transactions had to be transacted on exchange or with margin posted, what the impact would be on our companies, and we have estimated the impact from a cash flow standpoint of between $200 and $400 million per year, and that would have a significant impact because again, we are in the midst of a major capital expansion, and in some cases, that is ½ of your capital budget for the year. So it is a significant number, and again, I think that companies, if they were subject to those sorts of margin requirements, they would back off of their hedging, most likely, and to some degree redirect money toward other things that were in capital spend programs and so on.

So it would have a negative effect, and that is why it is so important that our companies are not in any way classified as financial entities and that the end-user status is robust.

Mrs. HARTZLER. Would it have an impact on the rates of your rate payers if they have $200, $400 million more in capital needed, I assume you would pass those on?

Mr. MCMAHON. Yes, absolutely. I mean there is absolutely an impact because at the end of the day, we are a rate-regulated industry. We are in the middle of this, in the midst of this on an industry basis about a $90 billion per year capital spend, and your average company's capital budget may be in the range of about $1 billion. So having the ability to manage that price risk as we do right now where we don't need to post margin, where we are end-users, it is very cost effective. And our customers get the advantage of the fact that we are very creditworthy. So our counterparties don't ask us to post margin. But as Mr. Monroe said, in some cases,

if we do post margin, we want to do something like use a power plant or use a physical asset. And having that flexibility is very important.

So these issues all kind of tie together, but at the end of the day, it is about delivering affordable rates, reliable rates to our customers.

Mrs. HARTZLER. Exactly, and stable, like you mentioned earlier.

Mr. MCMAHON. Absolutely.

Mrs. HARTZLER. Affordable, reliable and stable. I thought that was very good. In your opinion, how should the definition of *financial entity* be changed to ensure the commercial end-users are not inadvertently regulated as a financial——

Mr. MCMAHON. Well, from our perspective, and thank you for the question, our perspective is commercial end-users should be explicitly excluded from that definition so that we will not be sort of brought in through the actions of Prudential Regulators or the CFTC into that definition. We should be explicitly excluded.

Mrs. HARTZLER. Okay. Well, we are going to keep trying to work, help that happen.

Mr. MCMAHON. Thank you so much.

Mrs. HARTZLER. You bet. And I wanted to ask Mr. Cordes a question here because yesterday I asked Commissioner O'Malia and Wetjen about the damaging proposed rule on residual interest in same-day margin calls for farmers and ranchers. And I am cautiously optimistic from their answers. I don't know if you had an opportunity to hear that but that changes will be made, and they feel like there is staff drafting such as we speak. But for the record, can you please elaborate on why the proposed rule could harm farmers and ranchers?

Mr. MCMAHON. Yes. I did catch part of that testimony, and it is good to hear that some things are being redrafted and looked at. I would say from our perspective, if it is not, here is what is going to happen. Going forward, you will have to be ready for that one-day event that might happen once or twice a year, and for a firm like ours or in our industry where you are normally hedgers, and if you get a big market move-up, you have to be prepared to have that money on your balance sheet at that time, not when the margin call shows up at the end of the day or later, at that time. There are periods in our system in the last few years, and some of these days, it might be $100 million a day needs to be—you would have to throw on your balance sheet just to be ready for that one-day event. Firms are not going to do that. What you are going to do is you are going to say, "Okay, customer, we are going to have you put some skin on this game, and by that, you are going to have to increase your margin requirement that is on deposit with us." That is going to affect their working capital, and as I think we have heard on some of the other ones, working capital is precious, and that costs resources and ultimately hits the bottom line.

Mrs. HARTZLER. Absolutely, as——

The CHAIRMAN. The gentlelady——

Mrs. HARTZLER.—the farmer who—yes, okay.

The CHAIRMAN. The gentlelady's time has expired.

Mrs. HARTZLER. Thank you.

The CHAIRMAN. Mr. Davis for 5 minutes.

Mr. DAVIS. Thank you, Chairman Conaway and as it always is on these Committee hearings, when you are one of the last to ask questions, I had a lot of great questions to ask you, but almost all of them have already been asked. Mr. Chairman, am I the last questioner?

The CHAIRMAN. In this round.

Mr. DAVIS. In this round? Oh, another round. Okay. Well, then I will keep going. I was going to yield back. I had some discussion questions, especially from Mr. Cordes and Mr. Monroe, but again, they have already been asked. What we have seen here today and what we continue to see is laws like Dodd-Frank, that have great intentions, have consequences. And from the testimony that all of you have given us is the consequences are going to be passed on to the consumers. The flight I take on Southwest Airlines from Reagan National to St. Louis, to comply with these rules, the cost that I and so many different consumers in this country will pay will go up. The cost to provide electricity will go up. The cost to provide our agricultural products in central and southwestern Illinois to our local grain elevators will go up, the law of unintended consequences when it comes to Dodd-Frank.

And I know there are concerns. We have agreements, and there are those who disagree with the effectiveness of this piece of legislation. And with that in mind, you have all been asked specific questions by different Members of this Committee. I want to know from each of you, if you decide, is there any question that we haven't asked you and is there an issue when it comes to Dodd-Frank that we have not addressed that you would like to let the Committee know is a concern with your industry and with your particular business? So with that, I will start with Mr. Cordes. If you have any issues?

Mr. CORDES. Not specifically an issue, but it gets back to what we talked about this one-size-fits-all, and your original comments about—and I hear this a lot from our customers in the industry saying okay, what did we do? Why are we subject to this stuff? We were not the cause of all this. We understand there is Dodd-Frank legislation, but why are we being asked to do these kind of things and why are my costs going up and what can we do about it, seems to be kind of the general comments that I hear back.

Mr. DAVIS. Thank you. I hear that from many of my farmers.

Mr. KOTSCHWAR. I will get a little more granular with you. One of the things that hasn't been talked about today but is on CMC's list of things we are concerned about is it was part of the position limits rule that got tied up in court. We are going to be soon, if they resurrect it the way it was in the proposed rule, we are going to be doing daily reporting of physical positions. Currently it is agricultural commodities only, and they are reported to the Commission on a monthly basis. And we went round and round with the Commission on that as they were developing this particular part of the rule. We thought we had won that particular battle, too, and they said, okay, you are right. We will continue to allow you to do monthly reports. However, when we looked at the fine print it is monthly reports of daily positions. If you look at the history of the CFTC on these physical reports, at one time they were doing them on a weekly basis, but that was just way too much information for

CFTC. So they pushed it back to a monthly basis. So that is something else. This is something they were getting ready to have the industry start doing for from our perspective very little benefit, and it is still percolating out there.

Mr. DAVIS. Okay.

Mr. MCMAHON. I think from the electric utility perspective, the one issue that would be very helpful would be to have, that we haven't discussed already, is to have that Memorandum of Understanding between FERC and the CFTC that was mandated under the Dodd-Frank Act, to actually have it hammered out, put in place, because I think that would help to address some of the regulatory uncertainty that some of the other panelists have alluded to with respect to jurisdiction and some of the issues between the cash market, the futures forwards and derivatives markets. So I think that would be very helpful.

Mr. MONROE. I would just want to make it crystal clear that the additional $60 million that we talk about in terms of cost to Southwest from the real-time reporting rule is not some sort of $60 million that is going to the government in a new tax or to some regulative group. This is a group of hedge funds that have written specific—they have technology that they have built that has been handed to them by our government to have free information that they then use to trade against our counterparties, and it costs us more. And so that is money going from Southwest to hedge funds, just to be very clear about that.

Mr. DAVIS. Thank you.

Mr. SOTO. To echo remarks from Mr. McMahon, I have talked a lot about uncertainty and regulatory uncertainty today, and a lot of that derives from transactions that have traditionally been regulated by FERC that are now being regulated by the CFTC or trying to be regulated or questioned to be regulated by the CFTC as swaps. What we really would like is for Congress to sort out and say, look, FERC, you take care of these transactions and the CFTC, you take care of these transactions. Right now we have this crazy Venn diagram of overlapping jurisdictions, and it is causing disruptions in the industry. The Dodd-Frank Act, Congress has already included provisions to sort out the jurisdiction between the CFTC and the SEC. Is there something that can be done between FERC and the CFTC?

Mr. DAVIS. Mr. Guilford for a couple seconds?

Mr. GUILFORD. Yes. I would ask who has the big picture? In Congress for example you have division of responsibilities between agriculture, financial services and banking. Who has the big picture between all three? We created a massive piece of legislation that ostensibly gives responsibilities to four different agencies, each of which overlap, some of which don't necessarily overlap but could. Who has the big picture over all of those things? Because what we did, while it may have been important in many instances, has created an enormous amount of not only uncertainty but additional cost and a very time trying to sort out what to do next.

Mr. DAVIS. All right. Thank you. If I had time, I would yield it back, sir.

The CHAIRMAN. Well, the record reflects that you are over about a minute or 2, and we will take that into consideration at the next hearing.

I recognize myself for 5 minutes, second round. Mr. Soto, on the delay of the historical reporting requirements back in April, what impact is that having on your membership in terms of challenges in reporting and what impact would a second no-action letter have on your membership?

Mr. SOTO. The no-action relief is actually giving the industry a little bit of a breathing room and understanding what their compliance obligations are. So in that respect, it was helpful that the agency provided some relief, but it really recognizes that the process for defining the regulatory obligations is not strong enough. So if it comes to the next deadline, either additional no-action relief is required, but really what is required is for the agency to issue final rules that are clear, and it is strengthening that agency rulemaking process that is important.

The CHAIRMAN. All right. One of the things we have talked about is the cost-benefit analysis and how we are going to try to strengthen those provisions in the bill. Looking back at Dodd-Frank and the estimates of what the cost and benefits were going to be to the system, can any of you or would any of you be willing to quantify the differential if any between what the Commission said was going to be the costs of compliance with all of these new regulations in various areas and what your personal experience or your members' experience has been in actual costs of compliance and if you have been able to quantify that for the Committee? Mr. Cordes?

Mr. CORDES. I don't remember exactly what was stated in the bill, but I would tell you from our perspective, whether it is ourselves as CHS or other members within NCFC, pretty much everyone would give you the response that their costs and compliance are probably double what they were 3, 4 years ago.

The CHAIRMAN. Yes, thank you for that. I was trying to get a differential between what the CFTC said were going to be your costs and what has been the actual experience. And some of that may be proprietary that you don't want to fess up to. Does anyone have a number? Well, if you think of a number or if it comes to you, we are going to try to defend strengthening the cost-benefit analysis in the bill, so we will be working through those provisions.

I want to thank our panel for being here today. I also want to ask unanimous consent to include in the written record the comments from the Coalition for Derivatives End-Users and the comment from ICI and ABA.

[The information referred to is located on p. 87.]

The CHAIRMAN. Before we adjourn, I would now like to turn to the Ranking Member for a closing statement.

Mr. DAVID SCOTT of Georgia. Well, thank you very much, Mr. Chairman. Let me just extend my great appreciation to each of you for coming, taking the time out of your busy schedule to come. Your viewpoints have been well-appreciated. We have a number of challenges before us, and we are going to get there and we are going to avoid another financial crisis for sure. So thank you very much for coming.

The CHAIRMAN. I also want to thank our Members. Clearly the Dodd-Frank law itself as well as the regulations that have been put in place to try to implement it and grant guidance to the system are going to cost the industry and ultimately customers more money. The offset to that should be that there are benefits to the markets, that the markets are better protected, that there is less systemic risk in what is going on. What my relatively naïve view is that we are going to spend an awful lot of time on risks that can never reach the systemic level and the costs associated with all of those compliance costs on risks that really, at the end of the day, don't make a big deal, and that we have lost sight of the bigger issue.

Dodd-Frank, in my view, was intended to prevent a systemic meltdown. I am hard pressed to gather up many, or all, of your users at any one point in time and have them do something stupid that would systemically put risks to the overall financial market, and yet, we have burdened them immensely with additional regulations.

And so one of the things we will try to do with the reauthorization is not repeal Dodd-Frank, not undo it, but look at it particularly from a common-sense standpoint and say do we really need that information every single day in order to regulate what we need to regulate? There are risks in every market. There are risks in every transaction that you take. That is why people make money and lose money. But it is the systemic protection of the markets and the fairness of those markets that ought to be the deal. And we see an awful lot of this regulation that at the end of the day does not protect from a systemic meltdown; particularly that meltdown that drove Dodd-Frank.

I thank each one of you for coming here, the preparation that you did, the money that you spent getting here and all that team behind you that put together your very informative written comments. Those will of course go into the record, and I have an announcement. Under the rules of the Committee, the record of today's hearing will be held open for 10 calendar days to receive additional material and supplemental written responses from the witnesses to any questions posed by a Member. This hearing of the Subcommittee on General Farm Commodities and Risk Management is adjourned.

[Whereupon, at 12:04 p.m., the Subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED LETTERS BY HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

July 23, 2013

Hon. FRANK D. LUCAS,
Chairman,
House Committee on Agriculture,
Washington, D.C.;

Hon. COLLIN C. PETERSON,
Ranking Minority Member,
House Committee on Agriculture,
Washington, D.C.

Re: End-User Support for Adding H.R. 634 and H.R. 677 to Legislation Reauthorizing the Commodity Futures Trading Commission

Dear Chairman Lucas and Ranking Member Peterson:

The Coalition for Derivatives End-Users, representing hundreds of end-user companies that employ derivatives to manage risk, write in strong support of adding H.R. 634, the *Business Risk Mitigation and Price Stabilization Act of 2013* and H.R. 677, the *Inter-Affiliate Swap Clarification Act*, to legislation reauthorizing the Commodity Futures Trading Commission (the "CFTC"). These two vital bills would help prevent unnecessary and harmful regulation of derivatives end-users and preserve jobs. We have attached our June 11, 2013 letter to the U.S. House of Representatives in support of the two bills. The letter provides a sense of the range of end-user companies that stand behind these important bills.

This Committee, of course, is well aware of these two end-user bills, and the Coalition commends your efforts in moving the legislation toward enactment. On March 20, 2013, this Committee ordered both bills reported by unanimous voice votes. H.R. 634 passed the House last month by a vote of 411–12 and we are optimistic that passage of H.R. 677 will soon follow. These are commonsense bills that assist non-financial end-users in targeted, narrow ways that are consistent with the intent of Congress in passing the Dodd-Frank Act and that address problems not solved by regulatory action.

Both bills are urgently needed due to the impending application of regulatory requirements on end-users. H.R. 634 is needed because regulations proposed by the Prudential Banking Regulators have interpreted the Dodd-Frank Act as mandating that margin requirements be imposed on all swaps, including those entered into by non-financial end-users. The CFTC's proposed regulations, while preferable to those proposed by the Prudential Banking Regulators, do not provide end-users with the predictability and assurance that H.R. 634 provides. As noted in the attached letter, a 3% initial margin requirement applied to end-user transactions could cost more than 100,000 jobs.

H.R. 677 is urgently needed as well. Under CFTC rules, clearing requirements will apply to all swap market participants beginning this coming September. H.R. 677 would prevent regulators from denying non-financial companies the use of the end-user clearing exception because they have chosen to hedge their risk in an efficient, highly-effective and risk-reducing way—through the use of a centralized treasury unit ("CTU"). The CTU provision of H.R. 677 is especially important, as it makes clear that non-financial end-user companies that are using swaps to hedge or mitigate non-financial risks will not be disparately treated based on corporate structure and will not be subject to regulation that disadvantages them for employing what is a best practice among corporate treasurers.

To ensure timely consideration of these bills and to prevent unnecessary and harmful regulation of derivatives end-users, we request that both bills be included in legislation to reauthorize the CFTC if they have not already been enacted by the time that your Committee reports out the reauthorization.

Throughout the legislative and regulatory processes surrounding the Dodd-Frank Act, the Coalition has advocated for strong regulation that brings transparency to the derivatives market and imposes thoughtful new regulatory standards that enhance financial stability while avoiding needless costs. The Coalition appreciates very much your bipartisan legislative efforts to focus regulation where it is needed most by removing the burden where it will cause harm and provide no benefit.

Sincerely,

Coalition for Derivatives End-Users.

ATTACHMENT

June 11, 2013

U.S. House of Representatives,
Washington, D.C.

Re: End-User Support for H.R. 634 to Protect Derivatives End-Users from Unnecessary Margin Requirements and for H.R. 677 to Preserve Central Hedging and Prevent Unnecessary Regulation of Inter-Affiliate Swaps

Dear Representative:

The undersigned companies and organizations that employ derivatives to manage risk—write in strong support of H.R. 634, the *Business Risk Mitigation and Price Stabilization Act of 2013,* and H.R. 677, the *Inter-Affiliate Swap Clarification Act.* These two vital bills would help prevent unnecessary and harmful regulation of derivatives end-users and preserve jobs.

H.R. 634 would ensure that regulators would not impose unnecessary margin requirements on many end-users. 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. While the regulations proposed by the Commodity Futures Trading Commission (the "Commission") are preferable to the regulations proposed by the Prudential Banking Regulators, the Commission's regulations do not provide end-users with the predictability and assurance that H.R. 634 provides. According to a Coalition 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 120,000 jobs. We need Congress to step in and clarify that end-users will continue to have the ability to manage risk without the threat of having unnecessary initial and variation margin requirements imposed on them. In short, we need this bill. In the 112th Congress, an identical bill (H.R. 2682) received overwhelming bipartisan support when it passed the House on March 26, 2012. This year's version of the bill was ordered reported by the House Agriculture Committee by unanimous voice vote and by the House Committee on Financial Services by a vote of 59–0.

H.R. 677 would prevent certain internal, inter-affiliate trades from being subject to regulatory burdens that were designed to be applied only to certain street-facing swaps. It also would prevent regulators from denying non-financial companies use of the end-user clearing exception because they have chosen to hedge their risk in an efficient, highly-effective and risk-reducing way—through the use of centralized treasury units. Regulators have proposed a clearing exemption for inter-affiliate trades, but it would impose unreasonable conditions on financial end-users and would not address the centralized hedging unit problem. The Coalition believes that regulation of inter-affiliate trades should square with a simple economic reality: internal trades do not increase systemic risk. Thus, imposing requirements that are designed to address systemic risk on inter-affiliate trades would create costs without a corresponding benefit, placing substantial burdens on end-users and consumers and increasing costs to the economy. H.R. 677 also includes language that ensures bank swap dealers and major swap participants would not be able to take advantage of the clearing exemption in the bill that is intended for end-users only. The House Committee on Agriculture ordered the bill reported by unanimous voice vote and the House Committee on Financial Services approved the measure by a vote of 50–10. Last year's version of the bill received overwhelming bipartisan support when it passed the House on March 26, 2012.

Throughout the legislative and regulatory processes surrounding the Dodd-Frank Act, the Coalition has advocated for strong regulation that brings transparency to the derivatives market and imposes thoughtful new regulatory standards that enhance financial stability while avoiding needless costs. The Coalition encourages you to support these bipartisan bills when they are voted on in the U.S. House of Representatives and ensure that new regulations do not impede innovation, U.S. competitiveness or job growth.

Sincerely,

Air Products & Chemicals, Inc., Allentown, PA
Ameren Corporation, St. Louis, MO
American Honda Finance Corporation, Torrance, CA
Apache Corporation, Houston, TX
Bayer Corporation, Pittsburgh, PA
Blyth, Inc., Greenwich, CT
BP America Inc., Houston, TX
Business Roundtable, Washington, D.C.
Cargill, Minneapolis, MN
Caterpillar, Inc. Peoria, IL
Daimler North America Corporation, Montvale, NJ
Deere & Company, Moline, IL
DuPont Co., Wilmington, DE

DuPont Fabros Technology, Washington, D.C.
Eaton, Cleveland, OH
Edison Electric Institute, Washington, D.C.
Eli Lilly and Company, Indianapolis, IN
EnerVest, Ltd., Houston, TX
EV Energy Partners, Houston, TX
Exelon Corporation, Chicago, IL
Financial Executives International, Morristown, NJ
FMC Corporation, Philadelphia, PA
Ford Motor Company, Dearborn, MI
GE, Fairfield, CT
General Motors Company, Detroit, MI
Hallmark Cards, Inc., Kansas City, MO
Hardinge Inc., Elmira, NY
HCA, Nashville, TN
Health Care REIT, Toledo, OH
Helen of Troy, L.P., El Paso, TX
Hercules Offshore Inc., Houston, TX
Hersha Hospitality Trust, Harrisburg, PA
Honeywell International, Morristown, NJ
IBM Corporation, Armonk, NY
Independent Petroleum Association of America, Washington, D.C.
Johnson Controls, Inc., Milwaukee, WI
Lockheed Martin Corporation, Bethesda, MD
MAHLE Industries, Incorporated, Farmington Hills, MI
Mars, Incorporated, McLean, VA
McDonald's, Oak Brook, IL
Medtronic, Inc., Minneapolis, MN
Merck, Whitehouse Station, NJ
MillerCoors, Chicago, IL
Motor & Equipment Manufacturers Association, Washington, D.C.
National Association of Corporate Treasurers, Reston, VA
National Association of Manufacturers, Washington, D.C.
National Gypsum Company, Charlotte, NC
Nielsen, Wilton, CT
Peabody Energy, St. Louis, MO
Sealed Air Corporation, Elmwood Park, NJ
Siemens Capital Company LLC, Iselin, NJ
Simon Property Group, Indianapolis, IN
The Boeing Company, Chicago, IL
The Coca-Cola Company, Atlanta, GA
The Dow Chemical Company, Midland, MI
The JBG Companies, Chevy Chase, MD
The Procter & Gamble Company, Cincinnati, OH
Time Warner Inc., New York, NY
U.S. Chamber of Commerce, Washington, D.C.
United Launch Alliance, Centennial, CO
United Technologies Corporation, Hartford, CT
Volvo Group North America, Greensboro, NC
Whirlpool Corporation, Benton Harbor, MI
Zimmer, Inc., Warsaw, IN

July 24, 2013

Hon. FRANK D. LUCAS,
Chairman,
House Committee on Agriculture,
Washington, D.C.

Dear Mr. Chairman:

On behalf of the Investment Company Institute, ICI Global, The ABA Securities Association, and the American Bankers Association, we respectfully submit the enclosed statement for the record for the July 24, 2013, hearing of the Committee on the reauthorization of the Commodity Futures Trading Commission. This statement is in regard to the need to amend the definition of "foreign exchange forward" in the Commodity Exchange Act to include non-deliverable forwards.

If you or your staff have any questions, please call Karrie McMillan [**Redacted**] at the ICI, Dan Waters [**Redacted**] at ICI Global or Timothy Keehan [**Redacted**] at the ABA.

Sincerely,

KARRIE MCMILLAN,
General Counsel,
Investment Company Institute;

DAN WATERS,
Managing Director,
ICI Global;

CECELIA CALABY,
Executive Director and General Counsel,
ABA Securities Association;

TIMOTHY E. KEEHAN,
Vice President and Senior Counsel,
American Bankers Association.

ATTACHMENT

July 24, 2013

Statement for the Record for the House Agriculture Committee Hearing on July 10, 2013, on CFTC Reauthorization

The Investment Company Institute ("ICI"),[1] ICI Global,[2] the American Bankers Association ("ABA"),[3] and the ABA Securities Association[4] appreciate this opportunity to submit this statement for the record for the July 10, 2013, hearing of the House Agriculture Committee. We wish to bring to your attention an important issue concerning the fact that one type of foreign exchange forward—non-deliverable forwards ("NDFs")—has not been included in the exemption for foreign exchange forwards granted by the Secretary of the Treasury under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). As a result, NDFs are being subject to unnecessary and costly regulation, creating problems for both the providers and users of NDFs. These users include U.S. investors and businesses, such as exporters of agriculture and agriculture-related products, engaged in international trade.

The problem arises because of the definition of "foreign exchange forward" found in Section 1a(24) of the CEA (7 U.S.C. § 1a(24)). That definition, as amended by the Dodd-Frank Act, has been interpreted as excluding NDFs. This differential treatment of NDFs, we strongly believe, was not intended by Congress.

An NDF is a type of foreign exchange forward that is used when it is impractical or impossible for one of the currencies involved to be physically delivered outside the home country of that currency due to local law or other requirements. Because one of the currencies involved cannot be physically delivered, NDFs are settled in a single currency—usually U.S. dollars—in an amount that reflects the movement in the value of the underlying currencies.

The CEA, as amended by the Dodd-Frank Act, defines a foreign exchange forward as follows:

> The term 'foreign exchange forward' means a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange.

The differential treatment has resulted from the following language in this definition: "that solely involves the exchange of two different currencies." Both the Treasury and the CFTC staffs have interpreted this language as excluding NDFs from the CEA definition of foreign exchange forward. Therefore, when the Treasury, using its authority in the Dodd-Frank Act, exempted foreign exchange swaps and forwards from the definition of swap, NDFs were not covered by the exemption.[5]

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding and otherwise advance the interest of funds, their shareholders, directors and advisers. Members of ICI manage total assets of $15.3 trillion and serve over 90 million shareholders

[2] ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICI Global seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets in excess of U.S. $1 trillion.

[3] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its two million employees.

[4] The ABA Securities Association is a separately chartered affiliate of the ABA, representing those holding company members of ABA that are actively engaged in capital markets, investment banking, and broker-dealer activities.

[5] See "Determination of Foreign Exchange Swaps and Foreign Exchange Forwards" under the Commodity Exchange Act (Nov. 16, 2012).

There is every reason to believe that this result was unintended by Congress when it defined foreign exchange forward. There is nothing in the legislative history to indicate that Congress intended to differentiate NDFs or, in fact, was even aware of the existence of NDFs, which are a very small, though important, part of the foreign exchange forward market. Conversations we have had with Congressional staff have reinforced that view.

There is no valid public policy reason for treating NDFs differently than other foreign exchange forwards.

- NDFs and other foreign exchange forwards are treated as functional equivalents in the marketplace.
- Standard foreign exchange market documents treat NDFs as a subset of the foreign exchange forward.
- There is nothing in the record to show that NDFs present any material regulatory issues or risks different from other foreign exchange forwards.
- NDFs, like other forwards, functioned smoothly before and during the financial crisis.

NDFs are used by a variety of end-users and are an important tool to facilitate trade and investment between the U.S. and developing market countries. For example, asset managers (operating through mutual fund structures, private funds, or separately managed accounts) routinely use NDFs to hedge currency risks in investments in these countries. Likewise, U.S. businesses of all sizes engaged in trade with important developing economies such as Brazil, Taiwan, South Korea, India, and Indonesia use NDFs to limit currency risk in their businesses. These developing economies can be significant markets for U.S. agricultural products. Producers of such products often will wish to lock in prices and avoid currency fluctuations. Therefore, such producers may use NDFs as the only practical way to hedge currency risks.

The importance of this matter to a variety of businesses is evident from comment letters submitted to the Treasury and/or the CFTC requesting that NDFs, like other foreign exchange forwards, be exempted from the definition of swap. Among those submitting such letters, in addition to the Investment Company Institute and the ABA Securities Association, were the Coalition of Derivatives End-Users and the Committee on Investment of Employee Benefit Assets.

The inability to include NDFs in the Treasury exemption for foreign exchange forwards causes a number of problems:

- Because the electronic nature of this trading means it can be moved readily, the jobs and capital associated with NDF trading may easily be relocated to other jurisdictions that will not bifurcate the regulation of their foreign exchange markets or impose unnecessary costs on transacting in NDFs.
- Treasury already has determined that regulation of foreign exchange forwards as swaps is unnecessary and, indeed, counter-productive. These findings also should be applicable to NDFs. The additional regulatory costs imposed on NDFs, however, will increase the costs both for U.S. investors and for U.S. companies trading in developing countries.
- U.S. investors and companies seeking to avoid the extra costs imposed on NDFs will either choose not to hedge, thereby increasing their own risk as well as the risk to the U.S. financial system, or they may take the risk of trading NDFs in foreign jurisdictions that may lack U.S. regulatory and judicial protections.
- The differential regulatory treatment creates confusion among market participants and creates legal and operational difficulties for market participants in complying with CFTC rules.

It should be noted that including NDFs in the Treasury exemption would not by any means result in their being unregulated. In particular, NDFs would be subject to the same rules governing foreign exchange forwards.

Our associations have recently filed a petition for exemptive relief with the CFTC. Unfortunately, it is far from certain if and when the CFTC may consider our petition, and the CFTC has no legal obligation to consider it. Therefore, we recommend that this issue be addressed through a legislative clarification of the definition of foreign exchange forward.

Thank you for the opportunity to provide this recommendation for your consideration.

SUBMITTED LETTER BY KENNETH E. AUER, PRESIDENT AND CEO, FARM CREDIT COUNCIL

July 24, 2013

Hon. FRANK D. LUCAS,
Chairman,
House Committee on Agriculture,
Washington, D.C.;

Hon. COLLIN C. PETERSON,
Ranking Minority Member,
House Committee on Agriculture,
Washington, D.C.

Re: *CFTC Reauthorization*

Dear Chairman Lucas and Ranking Member Peterson:

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, 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."[1] Today, the Farm Credit System comprises four banks and 82 associations, 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, low-cost, and flexible funding to the farmers, ranchers, and rural cooperatives that borrow from, and cooperatively own, Farm Credit System institutions.

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, 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

[1] 12 U.S.C. § 2001(a).

[2] *See* Clearing Exemption for Certain Swaps Entered Into by Cooperatives, 77 *Fed. Reg.* 41940 (proposed July 17, 2012).

[3] See *id.* at 41943 ("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 41943–44.

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, 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 August 16, 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 on the implementation of Dodd-Frank and issues facing Farm Credit System institutions. For example, the Committee and the House of Representatives recently passed H.R. 634, the Business Risk Mitigation and Price Stabilization Act of 2013. 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] The intent of this provision is clear: 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. The CFTC's 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]

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[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.* 74284, 74289 n. 52, 74320 (Dec. 13, 2012) (to be codified at 17 CFR pts. 39 & 50).

[8] H.R. 634, 113th Cong. § 2 (passed the House of Representatives June 12, 2013).

[9] The Farm Credit Council also supports H.R. 2136, the Small Business Credit Availability Act, pending before this Committee. 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.

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 ultimately adversely affect the American economy, especially in rural and agricultural communities. The Farm Credit Council commends this Committee and the entire House for recognizing and addressing this important issue.

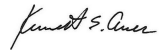
Notwithstanding that the House of Representatives and the CFTC have expressed their intent that margin requirements (either associated with clearing or with respect to uncleared swaps) should not apply to Farm Credit System institutions, the Farm Credit Administration has suggested that it has authority—separate 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,
President and CEO,
Farm Credit Council.

SUBMITTED QUESTIONS

Response from Scott Cordes, President, CHS Hedging, Inc.; on behalf of National Council of Farmer Cooperatives

Questions Submitted By Hon. K. Michael Conaway, a Representative in Congress from Texas

Question 1. If the CFTC had published a Dodd-Frank implementation timetable and followed it, would that have helped your businesses to plan for potential changes in the regulation of the derivatives markets?

Answer. It would have been helpful to have such a timetable, but more importantly to have a process that sequenced the rules in a logical fashion. Knowing what rules would apply to our company and counterparties earlier in the process would have allowed us to focus more clearly on preparing for implementation. For instance, as rules were being proposed and finalized that would apply to swap dealers, it was still unclear as to what transactions, and at what level, would determine who would be regulated as swap dealers. The uncertainty from that put business plans on hold and customers held back on their risk management trading given the uncertainty.

Question 2. Your testimony notes concerns over market liquidity in the over-the-counter derivatives market for hedgers. To date, have you seen or experienced any evidence of a lack of liquidity available to hedge against risks? What is your plan in the future if you find fewer counterparties to hedge your company's risks?

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[10] *See* Margin and Capital Requirements for Covered Swap Entities, 76 *Fed. Reg.* 27564, 27583 (proposed May 11, 2011) (to be codified at 12 CFR pt. 624).

[11] *Id.* at 27595 (proposed 12 CFR § 624.11).

Answer. Due, in part, to the uncertainly over the regulations, we've experienced a general decline of trading in swaps over the past three years. In the future, if swaps are not a viable risk management option, we would rely on the futures market. However, to the extent the futures market did not fit a specific hedging need (or a situation as outlined in the next response exists), we would be forced to increase our risk exposure, or limit certain business activities.

Question 3. In your testimony, you state that when a farmer goes to lock in a price for his future production of grain or milk by entering into a forward contract, someone has to offset that risk in the futures market, or potentially with a swap. Obviously, no one would be willing to be exposed without hedging their counterparty risk. Can you describe what type of financial resources it takes for a local grain elevator to hedge its future purchase obligations in the futures market, and how have the use of swaps helped ease the financial burdens of hedging risks?

Answer. In recent years, a considerable amount of working capital has been tied up to cover daily margin calls as a result of increased volatility in grain and oilseed markets. For example, an elevator that handles five million bushels of corn in a year may enter into 2,000 contracts to hedge those purchases. That elevator may have roughly 200 contracts outstanding at any one time. With initial margin of $2,400 per contract, $480,000 is required up front. Should the market have a limit up move (40¢/bushel) on a given day, an additional $400,000 is needed to cover that hedge. However, most cooperatives operate a number of elevators, not just one, so those financial requirements can increase significantly. And the need for such resources to hedge purchases, particularly during times of market volatility, can put a significant strain on working capital.

Thus, for farmers to continue to take advantage of selling grain forward during price rallies, many cooperatives have to either increase borrowing or look for alternative ways to manage such risk. Using the OTC market has become that alternative because commodity swaps are not currently subject to the same margin requirements as contracts on the exchanges. For example, in 2008 many grain companies were running out of working capital due to extreme volatility in grain prices and stopped forward contracting with farmers. CHS was able to enter into swaps to free up working capital so that it could continue to contract and forward price grain with its members. Today, we continue to use swaps to free up working capital so that we can employ it in other areas of our business.

Response from Lance Kotschwar, Senior Compliance Attorney, Gavilon Group, LLC; on behalf of Commodity Markets Council

Questions Submitted By Hon. K. Michael Conaway, a Representative in Congress from Texas

Question 1. If the CFTC had published a Dodd-Frank implementation timetable and followed it, would that have helped your businesses to plan for potential changes in the regulation of the derivatives markets?

Answer. Yes, that certainly would have been helpful. The haphazard finalization of these complex and interconnected rules has created extensive confusion for companies that are attempting to comply with a new regulatory regime. Couple the lack of any organized approach with the flurry of last minute no-action and exemptive relief letters that are constantly changing compliance dates and it is nearly impossible to feel comfortable that all regulatory obligations are being met.

Question 2. Do you think the exchanges do a sufficient job of setting and policing position limits in the energy markets? Are there potential consequences to shutting investment dollars out of the derivatives markets?

Answer. Yes, the exchanges have done a great job in not only setting appropriate limits, but also implementing and policing them in a sensible way, including how affiliated companies must aggregate positions for compliance with the limits. As for the appropriateness and/or effectiveness of position limits themselves and the notion of placing limits on a class of traders, the government cannot stop investor demand for physical commodity exposure. If regulators were to limit, for example, an exchange traded fund backed by crude oil derivatives in those markets, there is nothing to stop them from investing in the underlying physical commodity itself, in this case crude oil. These types of entities not only allow these physical market investments under their prospectuses, but at times they have shown interest in leasing or even owning storage capacity. This is one of many factors that must be considered when arbitrarily limiting trading activity.

Question 3. If the CFTC significantly narrows the scope of the *bona fide* hedging exemption from position limits to allow, for example, only positions that would be eligible for hedge accounting treatment to qualify as a *bona fide* hedges, how would that impact your business?

Answer. It would be detrimental. As a commodity merchant, Gavilon plays an important role in the physical commodity markets. Most agricultural commodities are produced seasonally yet consumed continuously, whereas energy commodities are produced continuously and consumed seasonally. CMC's members manage that flow of physical commodity and dynamically hedge it, which allows us to offer higher prices to producers and lower prices to consumers. We look at our net exposure to a particular commodity as a combination of physical, futures, and swap positions, and we hedge based on that net exposure. No one in our business ties a particular derivatives contract to a particular bushel of grain or barrel of oil. We are also hedging our infrastructure. We have empty grain bins that we know we will fill, empty, and refill again. The same is true for oil storage tanks. We are constantly looking for a better hedge, a better price, which is why these markets are as efficient as they are and we are able to offer the favorable forward contracts to farmers that we do. If this dynamic, portfolio hedging ability is limited, the result is quite simple: lower prices for producers and higher prices for consumers.

Question 4. It is my understanding that the CFTC already has access to your physical positions when you are using a hedge exemption from a position limit. Why then, did the Commission finalize a rule that would require you to track those positions on a daily basis rather than the current monthly requirement?

Answer. The Commission has the authority to ask us for cash market data any time they want it. For an international commodity merchant moving grain 24 hours a day, this is an impossible task to achieve on a daily basis. If the Commission has questions or concerns with a commercial company's ability to justify a hedge exemption, all they have to do is ask for more information and they will get it. Daily physical position reporting would be an enormous waste of resources for commercial end-users, if compliance is even possible at all. Equally as important, it is more data than the Commission can process while providing little regulatory gain, and therefore a waste of resources for them as well.

Response from Richard F. McMahon, Jr., Vice President of Energy Supply and Finance, Edison Electric Institute

Questions Submitted By Hon. K. Michael Conaway, a Representative in Congress from Texas

Question 1. If the CFTC had published a Dodd-Frank implementation timetable and followed it, would that have helped your businesses to plan for potential changes in the regulation of the derivatives markets?

Answer. Yes—certainty in the process with a realistic timetable for implementation would have helped EEI members during the rulemaking and implementation process as EEI members enter into long-term commodity contracts, and regulatory certainty is needed. The rulemaking process used by the Commission did not provide certainty as to process or outcome. For example, key terms, such as the definition of swap, were not defined until the end of the rulemaking process. Starting with definitions and then moving on to other issues would have allowed EEI members to focus on the issues impacting commercial end-users rather than focusing on all the issues at once.

Additionally, a defined rulemaking and rehearing process would have promoted certainty in the process. Instead, EEI members were forced to rely on Interim Rules and last-minute no-action letters, further increasing uncertainty and costs. Unfortunately, there is still lack of certainty to the process, and EEI members do not know if or when the Commission will respond to comments submitted on interim final rules. For example, EEI members began reporting swap transactions to the Commission on August 19 but, from July 2010 to the present, have spent on average over $1 million per company on hardware, software and consulting costs to implement the Commission's recordkeeping and reporting rules. Uncertainty still persists as to some of the requirements, and different swap data repositories require different information to be provided so it is likely that EEI members will continue to make system changes going forward, leading to additional costs.

Question 2. How have your members been impacted by the CFTC deciding to regulate forward contracts with imbedded "volumetric optionality" as swaps? What are the future consequences of this regulatory over-reach if the CFTC does not change its regulations?

Answer. Any uncertainty in definitions and implementation increases transaction costs for members and ultimately for consumers. In response to the Commission request for comment on the seven-factor test for imbedded volumetric optionality, EEI and others commented that the test was unclear and requested changes. Although the Commission stated that it "would benefit from public comment about [this] interpretation," to date, the CFTC has not responded to our members' comments. The

Commission's interpretation is overly narrow, difficult to understand and potentially classifies numerous common types of physical forward transactions as swaps or trade options. The CFTC's interpretation may result in EEI members modifying the structure of some forward contracts with volumetric variability or flexibility in ways that are less efficient, increase transaction costs and/or create additional risk.

In addition, due to the lack of clarity in the application of the test, there is uncertainty concerning the status of many transactions with volumetric optionality. It is possible that, under the test, counterparties to a transaction will view the same transaction differently, with some viewing it as a forward, some as a trade option and some as a swap. These differences all affect recordkeeping, reporting and other requirements. The cleanest solution would be for the Commission to recognize congressional intent and classify these transactions as exempt forwards because the transaction involves the sale of a non-financial commodity for deferred delivery that is intended to be physically settled. At a minimum, the Commission should provide clarification as requested in the filed comments as any uncertainty increases costs and decreases the likelihood of end-users entering into those transactions.

Question 3. It appears as though the CFTC, because of the way they defined "swap", may actually end up subjecting physical forward contracts to position limits. What kind of consequences would this have for your members?

Answer. The Commission's vacated Position Limits rule established 28 referenced contracts—four of which were energy contracts, including NYMEX Henry Hub contracts—for position limits. The Dodd-Frank Act requires the CFTC to exempt *bona fide* hedging transactions and positions from all position limits. The Commission narrowly defined *bona fide* hedging transactions to eight enumerated transactions unless the CFTC gave specific approval to a particular form of transaction. The *bona fide* hedge exemption from position limits is necessary to allow end-users of physical commodities to properly hedge their commercial risk. However, we fear that the CFTC's limitation of *bona fide* hedges to enumerated transaction types is overly limiting and runs counter to Congressional intent to exempt the hedging transactions of commercial end-users. 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.

Further, the Commission's definition of "swap" would subject some types of physical transactions to position limits, including physical forward transactions with volumetric optionality and physical commodity options. Examples that are particularly troubling are power transactions with volumetric optionality or power transactions structured "heat rate call options" that are priced using a formula that references NYMEX Henry Hub natural gas prices. These transactions are for the physical delivery of electricity and the pricing formula based upon natural gas prices acts as an embedded hedge to help ensure that electric utilities can meet their variable power needs at reasonable prices. These transactions are not for the purpose of speculating on commodity prices and are not even natural gas transactions; but, since they reference NYMEX Henry Hub natural gas prices, these physical power transactions would be subject to natural gas position limits. Physical transactions with embedded volumetric optionality and physical commodity options should not be subject to position limits.

Question Submitted By Hon. Doug LaMalfa, a Representative in Congress from California

Question. Some have suggested that the way to "fix" the special entity sub-threshold is for the CFTC to lower the *de minimis* registration threshold for the *entire* energy swaps marketplace to $25 million. What damage would be done to end-users, consumers, and the marketplace by lowering the registration threshold for all energy swaps to $25 million?

Answer. The likely end effect of lowering the threshold for all participants to $25 million would either be that (1) almost all users of swaps would be classified as swaps dealers, which would subject commercial end-users in the energy industry to bank-like regulation, including onerous capital and margin requirements, the inability to use the end-user clearing exception, and costly and burdensome recordkeeping and reporting requirements, or (2) entities would be forced to hedge only with banks or through physical forward transactions, which will expose hedgers to more risk and higher transaction costs. The end result of either option will be increased rates for customers. The Commission's rule states that an entity's swap dealing activity over the prior 12 months is capped at a gross notional value of $8 billion. An entity's aggregate effective notional amount of swap dealing reflects both the gross volume of swap activity that the entity engages in, and the relative monetary value of that activity, which reflects the volatile and non-fixed nature of the commodity price. This is different from the notional amount of a swap referencing a financial index

(*e.g.,* an interest rate swap) which is a set notional amount irrespective of whether the swap is 1 month or 20 years. Thus, a single relatively small swap contract could exceed the threshold amount of $25 million notional value. For example, a single 3 year 50 MW swap or a single 3 year 10,000 mmBtu/day swap would likely have a gross notional value well in excess of $25 million, based on projected prices from the PJM Interconnection, LLC, and Henry Hub. As a result, if the *de minimis* level is reduced to $25 million, one transaction could cause an EEI member to be classified as a swap dealer and subject to additional registration, capital & margin and reporting requirements. The volatility of commodity costs and the large amount of the transactions in the energy markets necessitates a higher *de minimis* level to accommodate the volatility in commodity prices and the need to accommodate customer usage levels. For these reasons, lowering the *de minimis* registration threshold for the *entire* energy swaps marketplace to $25 million would undermine Congressional intent to exempt commercial end-users from the burdensome requirements placed on swap dealers, resulting in higher costs of hedging and increased volatility for electric utilities and our customers.

Response from Chris Monroe, Treasurer, Southwest Airlines Co.

Questions Submitted By Hon. K. Michael Conaway, a Representative in Congress from Texas

Question 1. If the CFTC had published a Dodd-Frank implementation timetable and followed it, would that have helped your businesses to plan for potential changes in the regulation of the derivatives markets?

Answer. Yes. A published implementation timetable that had been adhered to would have helped our businesses, as well as the Commission, allocate time and resources by focusing on regulatory matters in order of their consideration. Additionally we believe that certainty in timing likely would have reduced market participants' expenses associated with preparation for compliance.

Question 2. What can Congress do to prevent the prudential banking regulators from implementing rules to require commercial end-users to post margin while prohibiting the use of non-cash collateral as margin? Does H.R. 634 provide the appropriate relief?

Answer. H.R. 634 provides an exemption for end-users from posting margin on uncleared trades and would satisfy Southwest's need for relief in terms of margin. It is important to Southwest and other end-users that any margin that is required to be posted be allowed in the form of non-cash collateral, which would allow commercial end-users to post as margin the assets that they most frequently hold. Use of non-cash assets as collateral allows end-users to have much more dynamic hedging programs. Southwest takes hedging very seriously not only because it is the responsible thing to do given the significant use of fuel in our business, but because it is a direct contributor to lower costs for our company. Hedging has been a good story for Southwest. Lower costs paid for a commodity our company must have in order to operate has generally led to healthier, more predictable business, and most importantly, lower fares for our customers.

Response from Gene A. Guilford, National & Regional Policy Counsel, Connecticut Energy Marketers Association; on behalf of Commodity Markets Oversight Coalition *

Questions Submitted By Hon. K. Michael Conaway, a Representative in Congress from Texas

Question. If the CFTC had published a Dodd-Frank implementation timetable and followed it, would that have helped your businesses to plan for potential changes in the regulation of the derivatives markets?

Response from Andrew K. Soto, Senior Managing Counsel, Regulatory Affairs, American Gas Association

August 28, 2013

Hon. K. MICHAEL CONAWAY,
Chairman,
Subcommittee on General Farm Commodities and Risk Management,
Committee on Agriculture,
Washington, D.C.

RE: The Future of the CFTC: End-User Perspectives—Supplemental Questions for the Record

* There was no response from the witness by the time this hearing went to press.

Dear Chairman Conaway:

On behalf of the American Gas Association (AGA), I am pleased to submit the following responses to the supplemental questions for the record regarding my testimony given during the July 24, 2013 public hearing of the Subcommittee on General Farm Commodities and Risk Management on *The Future of the CFTC: End-User Perspectives.*

Questions Submitted By Hon. K. Michael Conaway, a Representative in Congress from Texas

Question 1. If the CFTC had published a Dodd-Frank implementation timetable and followed it, would that have helped your businesses to plan for potential changes in the regulation of the derivatives markets?

Answer. Yes. As I noted in my testimony, AGA has worked cooperatively with the Commodity Futures Trading Commission (CFTC) and its staff throughout the rulemaking process to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act. We appreciate the magnitude and difficulty of the task that faced the CFTC following passage of the Act. Nonetheless, if the CFTC had published an implementation timetable and followed it, it would have benefitted the compliance planning efforts of large end-users such as AGA's member gas distribution utilities. In addition, a better sequencing of the CFTC's rulemakings would have also been beneficial for compliance planning. For example, in our June 3, 2011 comment letter to the CFTC, AGA argued that any sequencing of the final rules must begin with the foundational definitions of "swap," "swap dealer," and "major swap participant." AGA noted in that letter that industry participants need to understand whether and to what extent their activities would be regulated before they can assess how those activities should be regulated. AGA also noted that industry participants need to understand whether their activities would be regulated by the CFTC or the Federal Energy Regulatory Commission, and urged the CFTC to complete the negotiation of the Congressionally mandated Memorandum of Understanding with the FERC defining the respective jurisdictions of both agencies. As it turned out, the CFTC has only issued an *interim* final rule defining "swap" near the end of rulemaking process, and comments regarding the definition remain unanswered. Moreover, the CFTC has yet to complete negotiations with the FERC regarding jurisdiction.

Apart from an implementation timetable, business planning requires definitive rules clearly setting out the compliance obligations of industry participants. AGA believes that the CFTC's rulemaking process needs to be strengthened to provide better avenues for the public to obtain timely, definitive guidance from the Commission in the form of final agency action on the regulatory obligations implementing the Dodd-Frank Act. In particular, the public should have a meaningful opportunity to comment on the agency's proposals, and the agency should consider all relevant comments in fashioning final rules that are well-reasoned and supported by the record—not interim final rules, and not promises to consider issues later which have led to indefinite postponements. We are simply asking the agency to adhere to the fundamental requirements of the Administrative Procedure Act.

Question 2. Can you explain why large, end-users such as gas utilities, are having a hard time complying with the CFTC's new rules? Why is the "end-user" exemption from clearing not enough?

Answer. Large end-users such as AGA's member gas utilities are certainly used to regulation. As public utility companies, many aspects of their businesses are subject to a variety of regulatory regimes at both the state and federal level. The rates they charge for service are regulated at the state level by a public utility commission or other regulatory body, and their participation in the wholesale natural gas markets is regulated by the Federal Energy Regulatory Commission. As a result, gas utilities work hard to develop business operations and systems to ensure compliance with all applicable Federal, state and local regulations and take these compliance measures very seriously. Compliance, however, requires certainty. Companies need clear and definitive rules in order to understand their compliance obligations and develop plans to meet those obligations. That certainty has been lacking with regard to many of the CFTC's regulations implementing the Dodd-Frank Act.

The area of uncertainty that has had the most material impact on AGA members relates to the CFTC's rulemaking defining "swap." Gas utilities are currently entering into what have been traditionally considered to be normal commercial merchandising transactions to procure natural gas supplies to meet the peak winter time needs of their customers. AGA believes that these transactions are excluded from the CFTC's definition of a "swap" and thus not subject to regulation. As I noted during the hearing, however, there is tremendous disagreement in the industry as to how these contracts, all of which are settled by physical delivery of a commodity,

should be treated, which has disrupted normal contracting practices. Instead of providing clarity for any contract that is intended to settle via physical delivery, the CFTC's rules require market participants to apply subjective and difficult to understand multi-part tests to these transactions to determine whether they fall under the CFTC's definition of a "swap." Until the CFTC provides definitive rules clarifying the regulatory treatment of these physical commodity transactions, the turmoil in the industry will continue. Furthermore, the differing interpretations and understandings of the CFTC's "swap" definition will continue to lead to inconsistent reporting of swap transactions to swap data repositories and to the CFTC, thus making the CFTC a less effective market monitor and regulator.

The end-user exemption does indeed lessen the overall financial burden, but it does not broadly exempt end-users from the CFTC's regulation of the swaps markets. It only applies to the requirement to clear swaps on an exchange or other trading platform. Even as to uncleared swaps, there are still outstanding rulemakings by the CFTC and banking regulators as to the requirement to post margin or retain capital for such transactions. Thus, the end-user exemption is fairly narrow.

Further, end-users such as gas utilities are subject to the same recordkeeping and reporting requirements associated with their swap transactions that are not cleared. End-users are reporting or preparing to report uncleared commodity swaps and physical commodity transactions that might be considered "swaps" under the CFTC's interim final rule to swap data repositories. End-users are making significant resource investments to properly capture and report their swap transaction data, and paying monthly fees to the swap data repositories to ensure that their transactions are accurately reported. Even where end-users are not designated as "reporting parties" under the CFTC's rules, they are required to confirm and verify the uncleared swap transaction data that is reported on their behalf. Thus, gas utilities must not only come to an agreement with their counterparties on what is a reportable transaction, they must also verify and confirm that the swap transaction data that is reported accurately records the economic terms of the transactions. It is in this area that gas utilities and their counterparties are trying to sort out their compliance obligations, and the area in which current industry confusion and disagreement are having the greatest impact.

Question 3. What kind of internal processes surrounding roundtables, "no action" letters, and staff guidance would you like the CFTC to develop to improve their function as a major market regulator?

Answer. As noted above, AGA believes that the CFTC's rulemaking process needs to be strengthened to provide better avenues for the public to obtain timely, definitive guidance from the Commission in the form of final agency action on the regulatory obligations implementing the Dodd-Frank Act. While the CFTC's current regulations provide an opportunity to petition for a rule or modification of a rule (CFTC Rule 13.2), under the regulations there is no obligation on the part of the agency to act on such a petition, nor to act within a particular period of time. AGA recommends that the CFTC consider a commitment to act on petitions for rulemaking or on comments filed in on-going rulemaking proceedings within a particular period of time. AGA believes that having a defined, workable process for obtaining agency guidance in the form of clear, final rules will lessen the need for the industry to seek exemptive, or "no-action" relief from staff in order to obtain the necessary clarifications of the CFTC's rules.

Further, in April 2013, AGA joined CFTC Commissioner Bart Chilton in encouraging the CFTC to develop an End-User Bill of Rights, focused on providing reasonable and timely implementation of the Dodd-Frank Act as applied to end-users. In particular, Commissioner Chilton called for the CFTC to create a venue for end-users to air their concerns, to hold regular meetings with end-users, and perhaps establish an End-User Advisory Committee. AGA would support all of these proposals. In particular, AGA would like to see the CFTC host public roundtables focused on implementation challenges for end-users in the energy industry, providing sufficient public notice (at least 30 days) in order to give the public an opportunity to participate. The CFTC could use its authority in section 751 of the Dodd-Frank Act, to have the Energy and Environmental Markets Advisory Committee examine end-user issues. Alternatively, the CFTC could charter a standing committee under the Federal Advisory Committee Act. In addition, AGA would like the CFTC to provide public notice on its website or through press releases, that a specific division of CFTC staff intends to answer, or not answer, requests for no-action relief, interpretative guidance or exemptive relief requested by market participants. Currently, market participants are unable to track what public filings seeking relief have been received by various divisions within the agency, whether and when the agency intends to respond to these filings, and which division plans to respond.

Question Submitted By Hon. Doug LaMalfa, a Representative in Congress from California

Question. Some have suggested that the way to "fix" the special entity sub-threshold is for the CFTC to lower the *de minimis* registration threshold for the *entire* energy swaps marketplace to $25 million. What damage would be done to end-users, consumers, and the marketplace by lowering the registration threshold for all energy swaps to $25 million?

Answer. On June 7, 2013, AGA joined several other energy trade associations in urging CFTC Chairman Gensler not to lower the *de minimis* registration threshold for swap dealers. The associations noted that because swap dealers are subject to costly regulatory requirements, lowering the *de minimis* threshold would subject more market participants to such requirements and thus increase the costs associated with using swaps to hedge and mitigate commercial risk. For gas utilities, such cost increases must be borne by the customer, or the customer is left exposed to greater price volatility if the gas utility chooses to forego entering into swaps to hedge risk. More significantly, subjecting additional market participants to the swap dealer requirements may result in a reduction in the number of market participants willing to engage in swap dealing activity. Fewer swap dealers may result in decreased competition, leading to higher costs and/or less efficient hedging products, and potentially a greater concentration of swap transactions in systemically risky financial institutions. Increased transaction costs, decreased competition, and less liquidity can all result in consumers paying more.

Respectfully submitted,

ANDREW K. SOTO,
Senior Managing Counsel, Regulatory Affairs,
American Gas Association.

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