

# COMMODITY MARKETS OVERSIGHT COALITION

## **Briefing Paper for Senate Democratic Policy Committee Meeting November 6, 2009**

### **About Us**

The Commodity Markets Oversight Coalition (CMOC) is an informal alliance of trade and business groups, faith-based and social justice organizations, consumer advocate and market experts and academics. Our groups represent an array of interests, including commodity producers, processors, distributors, retailers, commercial and industrial end-users, and average American consumers. We believe that government policy in the commodity trading markets – including energy and agriculture – should preserve the interests of consumers and the health of the broader economy, and see that prices set by the commodities markets are a reflection of tangible economic fundamentals.

However, since organized in early 2007, CMOC groups have expressed concerns to Congress and to federal regulators about inadequate transparency, oversight and accountability in the commodity futures markets, and the existence of “dark market” trading activities that were contributing to excessive speculation and could open the door to fraud and manipulation.. In fact, many of our groups have testified before Congress and the CFTC on these issues.

### **Our Goals**

We believe that the commodities futures and derivatives markets were established as a price discovery and risk management tool for *bona-fide hedgers* of physical market exposures. Speculators play a role, in that they facilitate the risk-taking needed to keep the markets functional and liquid. However, in a letter to Congress as early as September of 2007, our groups expressed concern that trading in the commodities markets was becoming unhinged from economic fundamentals and noted the increasing role that speculators and financial investors were playing in these markets. And over the following year, we experienced the most extraordinary commodities bubble that the world has ever seen.

It is our opinion that the commodities bubble was primarily a result of speculative market forces that are still at play today. As our groups have communicated to Congress, this bubble could have been avoided and must never happen again. We believe that Congress must urgently pass comprehensive reform of the commodities futures and related derivatives markets.

### **Specific Recommendations**

#### ***Problem: Preventing Food & Energy Price Bubbles***

Speculators (or “invesculators”), viewing commodities as a potentially profitable new “asset class,” poured massive amounts of money into the commodities futures markets, which created a bubble in food and energy markets last year and threatens to do the same in 2009.

#### ***Solution: Require Aggregate Speculative Position Limits***

- Re-instate speculative position limits for all physically consumable commodities (e.g., crude oil, gasoline, heating oil, natural gas, wheat, corn, cattle, etc).
- Aggregate speculative position limits need to be set by the CFTC and need to cover all speculators and be aggregated across all trading venues, including Designated Contract Markets (DCMs), Foreign Boards of Trade (FBOTs) and the Over-the-Counter (OTC) markets.
- A separate much smaller limit needs to be imposed upon “Passive Investors” who are typically “long only” and “buy and hold” institutions. Passive investors should face stricter limits because they consume liquidity by buying and rolling futures positions, they drive prices upward because they are “long only” and they destroy the price discovery function of the markets in the process.

**Problem: Financial System Near-Meltdown**

The financial services industry utilized massive leverage in the OTC derivatives markets to create an opaque “shadow financial system” and make huge bets on housing, commodities and other markets. Because of the interconnected nature of the OTC markets, as firms began to lose massive amounts on their bets, it caused a domino effect that threatened to topple the entire financial system. Taxpayer backstops totaling \$24 trillion were required to prevent a complete meltdown and still the damage done to the real economy was tremendous. Millions of jobs were lost, trillions of dollars in savings evaporated and the economy was plunged into the worst economic crisis since the Great Depression.

**Solution: Mandate Exchange Clearing and Trading of all Derivatives**

- The SEC and the CFTC must be given the jurisdiction to police the OTC markets for potential fraud and manipulation, and to prevent excessive speculation.
- Congress should require OTC trading to move to a central clearinghouse. This will result in novation, where the clearinghouse becomes the Central Counterparty (CCP) to both sides of the derivatives trade. This eliminates the interlocking web of counterparty exposures and solves the problem of “too interconnected to fail.” The CCP will require all counterparties to post daily risk-based margin, thereby protecting the CCP against the bankruptcy of one of the clearing counterparties. The discipline of twice-daily assessing margin prevents players from becoming over-leveraged and unable to pay on their bets.
- All derivatives that can clear through an exchange should be required to clear through an exchange, and likewise, all derivatives that can trade on an exchange should be required to trade on an exchange.
- The SEC and CFTC must determine what is clearable with the presumption being that any swap or category of swaps accepted for clearing by a regulated clearinghouse is clearable.
- Every swap dealer and major swap participant must be subject to Set Aside Requirements on every un-cleared derivative on their books. These requirements make swap dealers “set aside” the daily cash offset necessary to cover their positions. This is critical to eliminate systemic risk and also to ensure that un-cleared derivatives are subject to the same requirements as cleared derivatives eliminating the incentive to avoid clearing.

**Problem: The CFTC’s Important Role in our Financial System Has Long Been Overlooked**

The CFTC has historically been underfunded, understaffed and under resourced. The CFTC typically receives one-ninth of the annual funding enjoyed by its sister-agency, the SEC. Funding has not kept pace with the size of the markets they regulate and, if Congress is to increase the CFTC’s authority over existing markets and emerging markets (such as environmental markets) – and it should – then additional resources are required. Further, the SEC, FTC and other federal commissions and agencies enjoy broader authority than the CFTC to investigate and prosecute manipulation.

**Solution: The CFTC Needs Additional Resources and Authority, and Congress should...**

- Increase CFTC funding for personnel and technology as appropriate.
- Pass S.1682, the “Derivatives Market Manipulation Prevention Act” to give CFTC the same statutory authorities to police market manipulation as the SEC, FTC and FERC.

**Regarding the “End-User” Exemptions**

**As it moves forward, the Senate should be mindful of the needs of *bona-fide* commodity hedgers and consumers.** While all CMOC members fully support transparency, oversight and accountability for all markets, Congress should be mindful of the potential effect new legislation may have on their ability to affordably and effectively manage risk. Therefore, we believe that any “end-user exemptions” must be **precisely worded** so as to prevent the creation of new loopholes for speculators, banks and commodity hedge funds, and limited to purely commercial (non-financial) market players utilizing futures and OTC derivatives markets for *bona fide* hedging purposes only.