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"Reauthorization of the Commodities Futures Trading Commission"
Committee on Agriculture, Nutrition and Forestry
July 17, 2013

Good morning Chairman Stabenow, Ranking Member Cochran and members of the Committee on Agriculture, Nutrition, and Forestry ("Committee"). Thank you for the invitation to Better Markets to testify today on the important topic of the Commodity Futures Trading Commission ("CFTC") and Commodity Exchange Act ("CEA") reauthorization process ("Reauthorization").

Better Markets is a nonprofit, nonpartisan organization that promotes the public interest in the domestic and global capital and commodity markets. It advocates for transparency, oversight, and accountability with the goal of a stronger, safer financial system that is less prone to crisis and failure, thereby eliminating or minimizing the need for more taxpayer funded bailouts. Better Markets has filed more than 130 comment letters in the U.S. rulemaking process related to implementing the financial reform law and has had dozens of meetings with regulators. It also engages in public advocacy, independent research and litigation in the public interest. For example, we file Amicus briefs in support of the CFTC and other agencies when their rulemaking is challenged. Our website, www.bettermarkets.com, includes information on these and the many other activities of Better Markets.

My name is Dennis Kelleher and I am the President and CEO of Better Markets. Prior to starting Better Markets in October 2010, I held three senior staff positions in the Senate: Chief Counsel and Senior Leadership Advisor to the Chairman of the Democratic Policy Committee, Legislative Director to the Secretary of the Democratic Conference, and Deputy Staff Director and General Counsel to what is now known as the HELP Committee. Previously, I was a litigation partner at the law firm of Skadden, Arps, Slate, Meagher & Flom, where I specialized in securities and financial markets in the U.S. and Europe. Prior to obtaining degrees at Brandeis University and Harvard Law School, I enlisted in the U.S. Air Force while in high school and served four years active duty as a crash-rescue firefighter. I grew up in central Massachusetts.

INTRODUCTION

The role of the CFTC in today's U.S. and global derivatives and commodities markets is far greater than at any point in its history. Until the Dodd-Frank Consumer Protection and Wall Street Regulation Act ("Dodd-Frank") was passed in July 2010, the CFTC's jurisdiction was limited to the US futures markets, which had $37 trillion in notional value in 2012 with over 7 billion trades taking place.[1] The worst financial crash since 1929 and the worst economic crisis since the Great Depression changed all that and responsibility for regulating the $340 trillion US swaps markets was added to the

[1] http://www.futuresindustry.org/volume-.asp

CFTC's mandate. As is widely known, this was necessary because the global financial crisis of 2008 was largely incubated in and triggered by dark, unregulated derivatives markets, and the Dodd-Frank Act amended the CEA to require the CFTC to regulate those markets and require transparency and prudent risk management so that such a calamity never happens again to the American people.

Given how extensive, indeed, historic these changes are, the Committee should consider renaming the CFTC as the "Commodities Futures and Swaps Trading Commission" ("CFSTC") so that its name more accurately reflects the breadth and depth of its jurisdiction and mission. After all, its jurisdiction has increased more than six times and has been extended to entirely new markets and products.

The financial reform law marked a vital, momentous and long-overdue modernization of the CEA. While these changes are critical for well-functioning markets, systemic stability, investor protection and avoiding more massive taxpayer bailouts in the future, they have not been welcomed by all. In particular, the sell-side of the industry, the derivatives dealer oligopoly, their trade groups and other allies, have relentlessly attacked the new provisions and the CFTC, trying to gut or weaken many of the provisions. This is only natural and to be expected because they were able to extract hundreds of billions of dollars in excess profits from non-transparent, unregulated derivatives trading because they had an unfair competitive advantage and an un-level playing field.

While that was great for the businesses, profits and bonuses of Wall Street, it was a nightmare for Main Street that had to pay the bill for the derivatives dealers reckless trading and investments. (The 2008-2009 financial crises are expected to cost the U.S. more than $12.8 trillion, as discussed below.) The financial reform law generally and the modifications to the CEA in particular are designed to change that, especially by requiring transparency and competition, both killers of Wall Street's excess derivatives profits.

Thus, it is no surprise that various industry participants – often pretending as though no financial crisis ever occurred or that derivatives had little to do with it – have pushed non-stop since its passage to repeal, water down and otherwise weaken the essential transformative changes to the CEA. Unfortunately, the present CFTC reauthorization process represents only the latest opportunity for the derivatives dealers club to attempt to weaken these vital legal protections for the US taxpayer and financial system. Stripped of their soothing sounding claims and ostensible concerns, the changes sought would risk – or result in – a return to the "wild west" of over-the-counter derivatives dealing that brought on the last crisis and assuredly will bring on the next one.

We would urge the Committee to reject pleas to reopen and re-litigate the financial reform law. Not only because there is little if any merit to doing so, but also because it has not even been put in place yet. Indeed, virtually all of the complaints about the law are entirely speculative for that very reason.

The law and its implementing regulations must be allowed to be put in place before changes are made to what is still very much a work in progress. Yes, changes in the future might be necessary and there might be unintended consequences that were not foreseen when the law was passed, but to make those changes now would be, at best, premature.

Moreover, suggestions that the CFTC should slow down, if not stop, its impressive efforts to implement financial reform should also be rejected. It is now five years since the financial crisis and three years since the financial reform law was passed, but much of financial reform is not yet in place, largely due to massive and unprecedented industry opposition. The CFTC is required by law to put the reforms in place and has taken this responsibility seriously. It should be praised, not punished, criticized, slowed down or stopped. In particular, the CFTC should not be held hostage to any other agency, not the SEC, international regulators or anyone else. Of course, the CFTC should work with and coordinate with fellow regulators and it has, to an unprecedented degree, but the requests for "coordination" and "harmonization" amount to little more than requests to subordinate the CFTC to other regulators. Worse, it is the substantive equivalent of regulator and rule shopping. That too must be rejected.

Notwithstanding what can only be described as a relentless, multi-front war on the agency, the CFTC has done an outstanding job in transforming the financial reform law into a derivatives market reality (even though we have often not agreed with particular provisions of certain rules). History will look back and laud its singular accomplishments. The CFTC is to be commended for this. However, it has been a struggle and, too often, needlessly so, mostly due to inadequate resources, which has deprived it of enough personnel and technology to do the job the law requires of it. Without a greatly increased budget and stable funding source, the CFTC will simply not be able to continue to implement the law, oversee these vital markets, ensure financial reform is a durable reality, and protect the American people from another derivatives-fueled crash.

There are other areas of great importance that this Committee should consider in connection with CEA reauthorization. In particular, as remarkable as it is, there are still high risk areas of the derivatives markets that remain, if not dark, with insufficient transparency, data and oversight. There are also areas that the Dodd-Frank law did not adequately cover and certain omissions that were not foreseen. We highlight some of those areas below and offer suggestions as to how this Committee might consider approaching them from a legislative perspective. In addition, there are areas in which the CFTC already has adequate authority, yet has failed to exercise it. Here, too, I offer suggestions as to how the Committee might act to address these issues through its overall supervisory role.

Importantly, the suggestions below are not intended to reopen or re-litigate the Dodd-Frank law, which we believe would be a grave mistake and a gross disservice to the American people. Rather, they are intended supplement the existing statutory framework to make it more effective as it pertains to the CEA. Broadly speaking, the comments will cover several key areas: funding, data, and other necessary augmentations and clarifications to the CFTC's mandate (or execution of that mandate) including high frequency trading, commodity index funds, physical commodity holdings, position limits and the SRO model. Finally, I will discuss why the CFTC's existing economic analysis requirement is appropriate, serves the public interest and should not be changed.

FUNDING

The CFTC is in charge of ensuring the transparency, stability, fairness, and integrity of 97.5 percent of the $340 trillion dark derivatives market in the United States.[2] It was in this shadowy market that the last financial crisis was invisibly incubated, with poorly collateralized, opaque derivatives exposures acting as a conveyor belt to transmit the crisis throughout the U.S. and global financial system. That financial collapse was the worst since the Great Crash of 1929 and has caused the worst economy since the Great Depression. The costs of that have been crippling, as an economic, fiscal, and human matter, with projected total costs to the US economy of $12.8 trillion. That is what gave rise to the financial reform law in general and derivatives reforms in particular.

The Commission has been diligently and expeditiously working towards finalizing the congressionally mandated rulemaking process to bring the Dodd-Frank derivatives reforms to life. As of July 12, 2013, the Commission has proposed 67 rules and finalized 46 of them.[3] In addition, just last Friday, it adopted cross-border interpretive guidance that is intended to regulate cross border swaps activities with a "direct and significant" impact on United States commerce. Chairman Gary Gensler recently stated that the Commission has met more than 2,000 times with members of the public and has held 23 public roundtables.[4] Moreover, the Commission has received and reviewed more than 39,000 comment letters on matters related to derivatives reform.

The CFTC has successfully implemented large portions of derivatives reform, setting the foundation for the new derivatives marketplace mandated by the Dodd-Frank Act. Rules have been finalized that create a mandate for certain swaps to be traded on Swap Execution Facilities ("SEFs") and cleared through Derivatives Clearing Organizations ("DCOs"), with the data from these transactions being reported to Swap Data Repositories ("SDRs"). The largest participants in these markets must register as Swap Dealers ("SDs") or Major Swap Participants ("MSPs"), who are subject to additional oversight, including external and internal business conduct standards, capital and risk management requirements, and reporting obligations.

These rules are not perfect. However, the CFTC is far ahead of the other agencies despite facing significant obstacles, including limited personnel and funding. While CFTC funding is in the jurisdiction of the Appropriations Committee, this Committee should do

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2 CFTC vs. SEC jurisdiction calculated from data presented in Bank for International Settlements, *Annual derivatives market report 2012* and corroborated using DTCC and CFTC data.

3 *See* http://www.cftc.gov/LawRegulation/DoddFrankAct/Dodd-FrankProposedRules/index.htm.

4 Testimony of Gary Gensler, Chairman, Commodity Futures Trading Commission before the U.S. Senate Banking, Housing and Urban Affairs Committee, Washington, DC (February 14, 2013), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-131

everything in its power to ensure a stable and adequate level of funding for the CFTC going forward so that it can effectively fulfill its crucial duties in the derivatives markets.

CFTC Cannot Carry Out Its New Responsibilities Without Sufficient Funding

The CFTC's entire budget for 2012, totaling $206 million, was less than half the $574 million dished out in compensation in 2007 to the top executives at the nine banks who received the first round of TARP funds.[5] Even the modestly expanded $315 million budget requested in the President's budget would still be less than half as large as the $647 million in fees that JP Morgan demanded in just one derivatives deal: Jefferson County before that municipality went bankrupt due to abusive derivatives entered into in connection with debt offerings.[6] In light of the importance of their vastly expanded responsibilities, the CFTC's funding requirements are reasonable, necessary and urgent.

While the Committee does not have jurisdiction over CFTC appropriations, it is nevertheless a key venue to discuss the agency's funding needs. With the economy still struggling to recover from the cataclysmic financial crisis, a repeat of which could well occur if the CFTC is unable to fulfill its new legal duties and responsibilities, this issue is more urgent than ever.

On September 15, 2012, Better Markets issued a report on the costs of the financial collapse and ongoing economic crisis. That report conservatively estimates that the sum of actual GDP loss and GDP loss avoided will total more than $12.8 trillion for the period 2008-2018.[7] This figure is consistent with the recent GAO report, "Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act," which states that those losses could exceed $13 trillion.[8]

In the context of a $12.8 trillion cost to the United States, increasing the starved CFTC budget to the approximately $300 million level requested simply has to be a priority for anyone serious about financial reform.[9] This funding will enable the CFTC to increase its personnel and technology modestly, and to the extent the Committee can facilitate that, it will be a worthwhile and necessary first step.

However, a CFTC entirely dependent on annual appropriations is an agency at risk of chronic underfunding. Moreover, requiring the CFTC to compete with so many other funding priorities is irresponsible given that the CFTC has a funding stream available to it. The Committee should consider authorizing self-funding of the CFTC through transaction, trade, quote or related charges, or – at a minimum – a deficit neutral funding model along the lines of that employed by the SEC. Indeed, given the large size of the futures and swaps

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5 http://money.cnn.com/news/specials/storysupplement/ceopay/

6 http://blogs.wsj.com/moneybeat/2013/06/05/how-much-did-jefferson-county-cost-j-p-morgan/

7 *See* Better Markets, "The Cost Of The Wall Street-Caused Financial Collapse and Ongoing Economic Crisis is More Than $12.8 Trillion," *available at* www.bettermarkets.com/cost-crisis.

8 *See* U.S. GOVERNMENT ACCOUNTABILITY OFFICE, FINANCIAL REGULATORY REFORM: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT, GAO-13-180, at 17 (Jan. 2013), *available at* http://gao.gov/assets/660/651322.pdf.

9 Hamilton, J., Gensler Wants 50 Percent More CFTC Money for Dodd-Frank Work (March 21, 2012), *available at* http://www.bloomberg.com/news/2012-03-21/gensler-wants-50-percent-more-cftc-money-for-dodd-frank-work.html.

markets, and the relatively small budget requested by the CFTC, a transaction fee much lower than that assessed by the SEC would suffice to fully fund the CFTC.

Unless the regulators have the resources to do their job, the American taxpayer will remain at risk of another crisis, and the markets will remain plagued by thousands of smaller inefficiencies and abuses that may not be systemically risky but which nevertheless represent a drain on the US economy by diverting resources away from their most productive use.

Staffing and Technology: Two Necessary Areas of Improvement

There is no genuine debate that the CFTC is woefully underfunded, understaffed and grossly lacking in technology. From 1999 to 2007, the agency shrunk from 567 full-time equivalents ("FTEs") to 437. Currently, the CFTC has 690 FTEs which is less than 10 percent more than at the peak in the 1990s.[10] Comparably, the volume of futures trading in the United States from 2000 to 2013 has exploded from 491 million contracts per year to over 9 billion contracts per year.[11] Also, the Dodd-Frank Act, for the first time, mandates the Commission to regulate the United States swaps markets, which is estimated to be approximately $340 trillion in notional value.[12] Under the Dodd-Frank Act, there will also be hundreds of new registrants such as SEFs, DCOs, and SDRs. These entities must be periodically inspected and examined to ensure that they have adequate compliance systems and procedures, and are actually using those systems to comply with the law. All this requires talented, experienced, and trained personnel, and that does not even address the CFTC's many other duties such as enforcement.

That the CFTC has to struggle for funding is particularly indefensible given that the civil penalties assessed by the CFTC against financial market participants who violate the CEA far exceed the CFTC budget. Last year, for instance, the CFTC assessed civil penalties of $416 million, over double its budget.[13] These penalties flow into the United States Treasury, making the CFTC a profit center for the government. The CFTC thus represents an excellent investment for US taxpayers – both protecting them against having to fund another bailout, and also clawing back funds from firms that break the law – often the very same institutions that were previously bailed out.

At the current staff level, the Commission would be critically understaffed even if it was only obligated to carry out its pre-Dodd-Frank responsibilities. The essential new responsibilities and authorities assigned to the CFTC under the Dodd-Frank Act only make that understaffing more severe and unacceptable. It is now known that the Commission has been unable to conduct annual examinations on major entities in 2012

[10] Testimony of Gary Gensler, Chairman, Commodity Futures Trading Commission before the U.S. Senate Banking, Housing and Urban Affairs Committee, Washington, DC (February 14, 2013), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-131.

[11] Acworth, W., Volume Climbs 11.4 percent to 25 Billion Contracts Worldwide, http://www.futuresindustry.org/files/css/magazineArticles/article-1383.pdf

[12] Gensler, G., Remarks on Dodd-Frank Financial Reform at George Washington University Law School (March 2, 2012), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-106.

[13] http://www.cftc.gov/PressRoom/PressReleases/pr6378-12.

due to limited resources and additional responsibilities.[14] This is simply not tolerable. Without properly designed examination programs and well-trained staff to carry out such examinations, the next LIBOR-style rate manipulation, the next MF Global-style fraud, and the next financial crisis currently being incubated unseen simply will not be identified and stopped.

As Commissioner Scott O'Malia has pointed out, the current technological limitations at the agency mean even an event as significant as JP Morgan Chase's so-called "London Whale" debacle[15] would currently go undetected, since "none of our computer programs load [Swap Data Repository] data without crashing."[16] According to Commissioner O'Malia, the current CFTC budget allows for only about $12 million for actual technology investment.[17] To put this in perspective, that is about as much as what a dozen or so large high frequency traders might pay for a year's worth of colocation fees at the CME and NYMEX.

This comparison is particularly apt since it is precisely the rising tendency of exchanges to sell or allow lucrative privileged data feeds to powerful market participants that has made technology so central to the modern markets. This speed war has encouraged a proliferation of algorithmic trading and High Frequency Trading ("HFT") in derivatives markets.[18]

Yet at the same time, this problem perhaps holds the seeds of its own solution. The Committee might consider whether a portion of such revenues should be required by law to support the agency responsible for regulating and monitoring this high tech minefield. This would enable the CFTC to keep pace with the changing technology of the marketplace, which is essential for even minimal oversight.

But technology is useless without the right staff to utilize it, and it must not be used as a pretext to divert funds from crucial personnel. Without qualified and experienced staff, the CFTC will not be able to effectively and efficiently regulate, even with the best technology in the world. In short, the CFTC needs technology and people and one must not be allowed to cannibalize the other.

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14 Commodity Futures Trading Commission Annual Performance Report, Fiscal Year 2012, *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/2012apr.pdf.

15 U.S. Senate Permanent Subcommittee on Investigations, "JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses" ("PSI Report")(March 15, 2013), *available at* http://www.hsgac.senate.gov/download/report-jpmorgan-chase-whale-trades-a-case-history-of-derivatives-risks-and-abuses-march-15-2013.

16 Brush, S., Dodd-Frank Swap Data Fails to Catch JPMorgan Whale, O'Malia Says (March 19, 2013), *available at* http://www.bloomberg.com/news/2013-03-19/dodd-frank-swap-data-fails-to-catch-jpmorgan-whale-o-malia-says.html.

17 http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-23

18 *See* High Speed Traders Exploit Loopholes, Patterson, J., et. al, (May 1, 2013), Wall Street Journal, *available at* http://online.wsj.com/article/SB10001424127887323798104578455032466082920.html?mod=WSJ_hps_LEFTTopStories .

To address the agency's grossly underfunded budget, the President requested $308 million and 1,015 FTEs for the fiscal year 2013.[19] If Congress does not provide sufficient funding to the CFTC and allow the Commission to properly monitor the markets and enforce its rules in the near future, it is not unreasonable to see another financial crisis looming just around the corner. Unfortunately, some on Wall Street appear to want the CFTC underfunded because it is like taking the police off the streets in a high-crime area. Risky trading in dark markets is highly profitable to many on Wall Street and very expensive for every other person in America. Wall Street received billions in bonuses while the U.S. taxpayers got the bill for trillions of dollars to clean up their mess. The only way to prevent them from doing that again is to make sure that the CFTC has the funds to do its job.

The CFTC's budget request of $315 million is insignificant in comparison to the roughly $37 trillion U.S. futures market and $340 trillion U.S. swaps market they are tasked with supervising. A fee sufficient to fund the agency at a level that would match their needs would hardly be noticeable by market participants, and would be considerably smaller than the SEC's Section 31 fees. The President has recommended such a step, the markets can clearly sustain it, and Better Markets fully supports it. All of the banking agencies are self-funded, as is the Consumer Financial Protection Bureau. The Committee should work to devise a fee-based funding arrangement that would enable the CFTC to catch up and then keep up with the vast growth of the markets it must regulate.

DATA

Despite the Dodd-Frank Act's drive toward transparency, several key areas of the markets remain dark, and the CFTC Reauthorization process represents an opportunity to address that. In particular, CFTC registration requirements should be expanded to cover:

- **all** funds providing returns benchmarked to the prices of physical commodities or their derivatives;
- **all** financial firms with physical commodity holdings; and
- **all** algorithmic traders and HFTs.

This would significantly boost the quality of the data available for policy-informed research, market surveillance and oversight, as well as enforcement within the CFTC.

Commodity Index Funds

Since 2008, a debate has raged over the impact of commodity index funds on food and energy prices. Today, the real debate is no longer whether or not these funds distort

[19] Commodity Futures Trading Commission President's Budget and Performance Plan, Fiscal Year 2014, *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2014.pdf.

market prices, but rather how large their impact is.[20] Congressionally-mandated collection of data on the activities of index funds would shed new light on this discussion, and would enable a truly informed and scientific analysis which would be to the benefit of all market participants, including in particular *bona fide* market participants.

Mandatory registration of these firms with the CFTC would enhance the CFTC's ability to collect data and otherwise regulate these traders' participation in commodity markets to a level where their impact on the markets could be understood and measured. In addition, where appropriate, the negative impact of such trading could be identified and reduced based on this market data. Importantly, firms engaged in this massive commodity index trading are sophisticated operations which already have the systems in place that produce this data on a routine basis. Providing such data to the CFTC would, therefore, not be burdensome or costly, but would provide an immeasurable benefit to regulators, the markets, and the public.

"Commodity index trader" should be defined to include any account, fund, commodity pool, or other investment vehicle that provides returns to investors benchmarked to one or more physical commodities or their derivatives.[21] The CFTC already has authority to regulate these entities and to impose position limits on them as it deems appropriate. However, so that the existing authority is even more clear, the Committee should specify that this group of traders – or any sub-group thereof – qualifies as a "group or class of traders" under the CEA for position limits purposes. This would clarify the CFTC's authority to restrict such trading or to attach conditions to it (including public disclosure obligations of the type required under securities laws for exchange-traded commodity funds[22]),

To the extent that commodity index traders' activities in commodity markets are appropriately regulated, *bona fide* market participants and the American consumer will benefit. Further, if the money in excess of appropriate, historically consistent amounts of commodity investment were invested elsewhere, the public would also benefit.[23]

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20 For a list of over 100 studies and articles finding that commodity index fund trading distorts commodity prices, see http://www2.weed-online.org/uploads/evidence_on_impact_of_commodity_speculation.pdf.

21 This definition should include electronically-traded funds (ETFs) backed by physical commodity assets. This definition should also include objective criteria for determining whether an investment vehicle is a "commodity index trader." Such objective criteria may include (1) that the vehicle is net long (or short) in all commodities in which they hold a position greater than 90 percent of the time and (2) that 90 percent or more of the replacement value of the fund is allocated to the vehicle's long (or short) exposures. An objective definition of this sort should be sufficiently flexible to cover funds that are restructured in order to avoid classification as a commodity index trader.

22 Such disclosure obligations would enhance the ability of investors to evaluate these investments. *See e.g.,* ETFs Imperil Investors as Contango, Pre-Roll Conspire, Bloomberg BusinessWeek, *available at* http://www.bloomberg.com/news/2010-07-22/etfs-imperil-commodity-investors-when-contango-conspires-with-pre-rolling.html. These disclosure obligations would also enable the market to distinguish between informed non-index-related trading and trading initiated by commodity index investors and therefore mitigate the harmful impact of the latter.

23 Some of this money would likely find itself in commodity-linked equities that would, in turn, result in greater investments in commodity production and processing, thereby reducing pressures on physical commodity prices. Other money re-allocated from commodity index investment would find itself in

Congress should provide the CFTC with additional direction and discretion to deal with commodity index traders in a manner consistent with the public interest.

Physical Commodity Holdings of Financial Firms

It is now widely known that banks have taken ownership of significant amounts of physical commodities and storage facilities.[24] The reported levels of ownership – with a single bank in some cases owning 25 percent of deliverable supply – are a clear threat to the orderly functioning of commodities markets.[25] Yet the precise levels of these holdings remain unknown.

The Reauthorization process represents an opportunity to close this material gap in reporting requirements, which were never previously necessary due to the fact that never before have banks owned physical commodities, and never in such large, market-moving quantities. Indeed, it was illegal for them to do so until the recent weakening of restrictions by the bank regulators.[26] This dramatic change requires data gathering, review, and, where appropriate, regulation.

It is no secret that banks and other institutions have been trading physical commodities for some years. The Wall Street Journal reported as early as June 2006 that "Dominant commodity traders such as Morgan Stanley and Goldman Sachs Group Inc. long have had strategies to own or lease fuel-storage terminals, oil tankers and power plants…[and] recently, those Wall Street firms have taken physical trading to new levels with bids to buy, not lease, distribution facilities such as pipelines and production facilities including refineries. Hedge funds also have gotten into the game of dealing in physical energy and even metals assets. "[27]

In 2008, JP Morgan joined the physical oil trade,[28] and it has been rumored that Morgan Stanley is the single largest physical jet fuel dealer in the United States.[29] In light of the ongoing manipulation cases in both financial indices[30] and commodity indices,[31] it is clear that improved scrutiny of these physical trading operations is both necessary and urgent.

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actively-managed commodity funds that would provide genuine liquidity to *bona fide* hedgers, in contrast to commodity index funds which absorb liquidity.

24 Sheppard, D., Leff, J., and Mason, J., Insight: Wall Street, Fed face off over physical commodities, Reuters (March 2, 2012), *available at* http://www.reuters.com/article/2012/03/02/us-fed-banks-commodities-idUSTRE8211CC20120302.

25 Desai, P., Baldwin, C., Thomas, S., and Burton, M., Goldman's new money machine: warehouses, Reuters (July 29, 2011), *available at* http://www.reuters.com/article/2011/07/29/us-lme-warehousing-idUSTRE76R3YZ20110729.

26 Chanjaroen, C., Morgan Stanley Will Seek Further Fed Exemption in Commodities, Bloomberg (September 24, 2008), *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=arV.SiJ8Bm8M.

27 Ann Davis, "Case Raises a Tough Query: When Do Traders Cross Line?" Wall Street Journal, June 30th 2006 available at http://online.wsj.com/article/SB115163341075595034.html

28 "JPMorgan to start physical oil trade, eyes $200 oil" Reuters, 15 May 2008

29 *See*, e.g. http://finance.fortune.cnn.com/2012/04/12/delta-oil-refinery/

30 http://www.guardian.co.uk/business/2013/jul/15/sfo-charges-two-brokers-libor

31 http://www.bloomberg.com/news/2013-07-15/u-k-regulators-consider-criminal-probe-into-oil-price-fixing.html

High Frequency Trading

HFT[32] is another new threat to the marketplace that could not have been foreseen by previous drafters of the CEA. New loopholes have been created, and are now being exploited, to the detriment of commodity market participants and, ultimately, the consumers they are meant to serve.[33] Indeed, we view HFT as one of the most important issues facing the U.S. markets today, especially as the new emerging derivatives markets infrastructure is being put in place as required by the Dodd-Frank Act.

Unfortunately, we are all too familiar with the many breakdowns, crashes, and debacles, often with very substantial investor losses, that have been caused by or associated with HFT:

- The Flash Crash in May 2010 was set off by a single large trade estimated at $4.1 billion in the S&P 500 E-Mini Futures Market. The cascade led to 20 minutes of extreme volatility, wiping out nearly $1 trillion of market cap before quickly and inexplicably recovering. The total economic cost of this event is unmeasured, but certainly huge. We were lucky it didn't happen near the market close – had the U.S. market closed before it recovered, the result could have been total economic disaster because money would have hemorrhaged out of the stock market overnight. In addition to the economic cost, the real cost of the flash crash was a loss of investor confidence.

- In August, 2011 the stock market swung up and down by over 4.4 percent on four consecutive days, alternating up and down days. It was wild, unprecedented volatility – only the third time in history that had happened, with the second time having been three years prior, during the crash of 2008. While the European crisis was becoming a more important issue at the time, this volatility was not warranted by major economic changes or historic macroeconomic events. This was computer-driven volatility.

- "Mini flash crashes" occur on a near-daily basis in individual stocks. Nanex has documented almost 2,000 instances of individual irregularities in stocks since August 2011.[34] Single-stock circuit breakers have failed to stem the tide of these incidents.

- IPO's in Facebook and BATS (itself an exchange) have gone horribly wrong due to technological fiascos, continuing to sour the already languid market for IPO's and

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32 While "HFT" is the commonly used term for high-speed computer activity in the markets today (and for that reason we use it in this letter), it is misleading to say the least. It would be much more accurate to call such high speed computer activity "high frequency quoting" because according to some reports as much as 99 percent of all computer generated quotes **do not** result in market trades. As we have detailed elsewhere, much of what is referred to as "HFT" appears to be for manipulative, if not fraudulent, purposes. *See* http://www.citizen.org/documents/hauptman-testimony-on-computerized-trading.pdf.

33 Patterson, S., Strasburg, J., and Pleven, L. High-Speed Traders Exploit Loophole, Wall Street Journal (May 1, 2013), *available at* http://online.wsj.com/article/SB10001424127887323798104578455032466082920.html.

34 http://www.nanex.net/aqck/aqckIndex.html.

costing untold numbers of jobs as companies cannot raise the capital they need to expand and hire.

- Few realize how lucky we were on Tuesday, July 30, 2012. An order to sell nearly $4.1 billion in the S&P 500 E-Mini Futures Market, the same size as what precipitated the Flash Crash, was executed three seconds before the market closed. There simply was not enough time for the waterfall of May 6, 2010 to repeat itself. What happens the next time when that same order is sent in a couple of minutes sooner? This quote from the Joint SEC/CFTC Flash Crash report should be a cause of concern for all: *"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."*[35]

- On Wednesday, July 31, 2012, Knight Capital Group – one of the largest market making firms, an official Designated Market Maker on the NYSE, had a software breakdown according to their CEO. The result? A loss for them estimated at $440 million, untold economic losses for retail investors with stop-loss orders in one of the almost 140 stocks that were affected and further erosion in investor confidence.

- In April of this year, high speed algorithmic trading was implicated in the 145-point market sell-off triggered by a fake post on the Associated Press Twitter feed.

- In May, the *Wall Street Journal* revealed that HFTs were essentially front-running other customers on the CME and thereby distorting prices. The article also cited a study by the Tabb Group which found HFT now comprises "about 61 percent of all futures market volume, up from 47 percent in 2008."[36]

Better Markets addressed this issue in testimony before this Committee on July 17, 2012, when Chairman Stabenow asked, "We're focused on important reforms in Dodd-Frank, but from your perspective, what else should we be paying attention to as we look to protect the economy and strengthen these markets?" On that occasion, I testified as follows:

> "… The second issue that really needs to be focused on that hasn't gotten much attention that we've tried to raise in 5 or so comment letters to CFTC is high-frequency trading, which is currently – the predatory conduct associated with that in our equity markets is causing the confidence in those markets to drop to one of the lowest ebbs ever. And that – that type of trading and predatory conduct is going to move into the new market infrastructure that's created in the commodity markets.

35 Summary Report of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues, Feb. 18, 2011

36 Jenny Strasburg, "A Wild Ride to Profits", Wall Street Journal, August 16 2011, available at http://online.wsj.com/article/SB10001424053111904253204576510371408072058.html

> "And you all are going to be here, mark my words, in future years, trying to figure out how to deal with those computer predators, in the same way, in the past, we tried to deal with the Peregrines and the people predators of the past, the computer predators of the future are not getting the attention. And now's the perfect time to start thinking about that. As you put this market infrastructure in place, you have the opportunity to address that on the front end, instead of having to address it after the fact, when you've got victims across the land."[37]

New data collection authorities specific to HFT are critical and would at the very least allow the CFTC to begin to take a systematic look at the behaviors and impact of high-speed computer trading generally (inclusive of HFT, but not limited to it, however defined). This would also help the CFTC enforce anti-disruptive trading practices and other anti-manipulation rules, which many market participants believe are being openly flouted by what is referred to as HFT.[38] As with commodity index funds, mandatory registration of all commodity HFTs with the CFTC is an essential first step. It is simply unacceptable that the CFTC should lack this crucial regulatory tool with respect to traders who possess the capacity to wipe out huge swathes of commodity markets in minutes just as they temporarily erased nearly one trillion dollars of stock market wealth during the flash crash. Many market participants have already complained that the markets are no longer effective as hedging instruments. How much more so if genuine commercial participants are driven to flee the markets by a flash-crash like scenario in commodity contracts?

The Committee may also wish to consider developing a definition of HFT for CEA purposes. The CFTC's Technology Advisory Committee has so far failed to come up with an appropriate definition of HFT due to, among other things, an over-reliance on special interest groups from the financial industry. For example, the CFTC definition failed to include any language on holding periods or inventory. This essentially had the effect of casting a very broad net with their definition. In fact, most institutional investors, even plain vanilla mutual funds, would be considered high frequency traders under the proposed definition.

Moreover, there are clear abuses relating to HFT, but very few enforcement cases. For example, the NYSE was fined $5 million by the SEC for sending data to HFTs through its proprietary feeds before sending it to the consolidated feed. This confirmed the fears frequently expressed by institutional and retail investors that they are facing a rigged stock market. The recent Thompson Reuters case, in which the New York Attorney General ordered the company to suspend its program under which it sells market-moving data 2 seconds earlier to premium subscribers, is another indication that market

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[37] Senate Committee on Agriculture Hearing "Dodd-Frank Wall Street Reform and Consumer Protection Act: 2 Years Later (July 17, 2012), *available at* http://www.ag.senate.gov/hearings/-dodd-frank-wall-street-reform-and-consumer-protection-act-2-years-later-.

[38] Institutional investors air HFT concerns, Financial Times (September 12, 2011), *available at* http://www.ft.com/intl/cms/s/0/d05f1e1e-dd0b-11e0-b4f2-00144feabdc0.html#axzz2S4D4xFCz.

participants today are not operating on a level playing field.[39] Price discovery is premised on sound information flows, and the HFT-driven culture of collocation, structural trading advantages and asymmetric information advantages for the fastest computerized trader is a dangerous threat to this cornerstone of the commodity markets.

FIVE FURTHER CRITICAL ISSUES TO CONSIDER

Beyond the above suggestions, there are five further key areas into which the Committee should look when considering updates to the CEA during the CFTC Reauthorization process.

CFTC Penalty Authority

At present, the CFTC's maximum penalty authority is tied to the gains accruing to the rule breaker. This is appropriate for manipulation and other activities that bring profit. However, a failure of compliance, a loss-making transgression, or a failed manipulation attempt may only allow maximum penalties that are paltry in comparison to the gravity of the offence. If penalties are not commensurate to the severity of the offenses, the incentives to comply with regulations are eroded, and the entire regulatory infrastructure and financial system itself is undermined. The Committee should therefore consider setting monetary penalties for individuals and entities at much higher levels than currently to ensure that those penalties serve the critically important purposes of punishment and deterrence.

At a minimum, the Committee should raise the maximum penalty for **all** violations of the CEA to the greater of three times the illicit gains or $1 million for individuals and $10 million for entities. This is a very important change, as it would enable the CFTC to impose more appropriate penalties not just for manipulation but for other violations of the CEA.[40] Currently, the maximum penalty for violations that do not constitute manipulation are considerably lower than for those that do.[41] However, this is an artifact of an outdated framework that was developed before the era in which CEA-covered financial instruments can now cause the entire financial system to collapse. In this new environment, the CFTC needs adequate authority to appropriately penalize violations that may be hugely significant in their possible consequences despite not constituting manipulation.

This issue has also been highlighted by several other parties, including CFTC Commissioner Bart Chilton,[42] the National Farmers Union, and The Commodity Markets Oversight Coalition representing end-users.[43] We urge the Committee to seriously consider it because without suitable deterrents industry participants will lack

39 http://www.bloomberg.com/news/2013-07-08/selling-a-sneak-peak-at-consumer-data-is-good-business-.html
40 17 CFR 143.8.
41 *Id.*
42 http://www.cftc.gov/PressRoom/SpeechesTestimony/opachilton-91
43 NFU and CMOC letters to the Committee on the topic of CFTC reauthorization.

sufficiently strong incentives to abide by CFTC regulations, with the whole market suffering as a result.

Absolute Limits on Financial Speculation in Commodities

There is academic evidence suggesting that the aggregate level of speculation in the market influences the behavior of prices, and that more speculation does not always mean more efficient prices. Yet the CFTC rule on position limits that was vacated by the Federal District Court (on procedural grounds and did not reach the merits) did not address the aggregate level of speculation in the market. The Committee should consider that stipulating a maximum overall level of speculation in the market may help to generate an orderly market, in which prices are more indicative of supply and demand. This would, of course, translate into individual limits, which would then be set at a level, in the aggregate, to keep speculation within the overall limit.

A corollary of this is that the Committee should consider further defining the concept of excessive speculation. Common sense would dictate that if the speculators in a market outnumber the *bona fide* hedgers then prices are by definition determined more by speculators than by hedgers. Therefore, at a minimum, a presumption that a market is excessively speculative when speculators outnumber commercial participants would seem warranted. In the past, this was not necessary, as it is only recently that speculators have come to dominate various commodity markets. Certain markets might be exempted by the CFTC (like electricity or natural gas), depending on specific considerations pertaining to those markets.

While the financial industry and the exchanges are adamantly opposed to such limits – naturally, since they have the perverse incentive to maximize profits by maximizing speculation – the end-user community on the whole feels very differently.[44] Given that the CEA defines end-users as the "primary constituency" of the commodities markets, the Committee should see to it that their interests are not sacrificed to promote those of the financial industry simply because the latter are able to lobby loudly, engage in lengthy, costly legal battles over rulemakings, and gain the support of the exchanges by providing vast volume that purports to improve liquidity but really just increases volatility and therefore costs for actual producers and consumers.[45]

Bona Fide Hedging

The concept of *bona fide* hedging is central to Title VII of the Dodd-Frank Act. Various key rules ranging from Swap Dealer registration to position limits to the clearing mandate hinge upon the definition of *bona fide* hedging. And yet, this definition – upon which so much hinges – is left open to the CFTC's discretion. As a consequence of this, different definitions have been applied in different contexts, and some definitions

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[44] For a small sample of complaints from end users, *see* http://www.reuters.com/article/2012/02/01/us-metals-jpmorgan-idUSTRE81019J20120201, http://www.ft.com/intl/cms/s/0/fa802828-94af-11df-b90e-00144feab49a.html#axzz2Z9J07jpd and http://www.iatp.org/documents/october-18-letter-from-cmoc-to-cftc-concerning-speculative-position-limits

[45] http://www.princeton.edu/~wxiong/papers/commodity.pdf

adopted by the CFTC have been wholly inappropriate for their intended use. Enacting a congressionally determined definition of *bona fide* hedging into the CEA would remove this ambiguity and inconsistency, and ensure that the definition used by the CFTC is suitable.

While the exact definition would require deliberation and perhaps hearings, in broad outline it is clear that it should include certain elements. First, *bona fide* hedging should be tied to specific lines of business and specific contracts. It is conceivable (and indeed likely) that part of an entity's book constitute *bona fide* hedging and another part not. Second, a *bona fide* hedge must be commensurate to the risk it is designated to hedge. In other words, an entity ought to be able to point to the business line it is hedging and demonstrate that the size of its derivatives positions that it claims as a hedge are appropriate for the commercial activities of that business line. Third, a *bona fide* hedge should not create complex new risks such as convexity.

These principles were clearly violated in the supposed "hedge" positions that caused the London Whale fiasco.[46] No doubt countless other positions within financial institutions and commercial firms deserve further scrutiny as to their suitability as a "hedge." It is simply not right that risky derivatives trades with no direct economic purpose be allowed to take place outside of the regulated system, with exemptions from position limits and clearing requirements. Not only does this build systemic risk, it also diverts capital away from productive uses at a time when the United States economy can ill afford to be under-supplied with capital simply to fuel the gambling habits and bonus addiction of a few to the detriment of the many.

Against this background, it is clear that all calls for a statutory definition of *bona fide hedging* must be carefully weighed.[47] There are companies that would gladly have the definition of a *bona fide* hedge expanded beyond all reasonable limits to include any activity – including speculation – carried out by a company trading physical commodities. Such an approach would have deeply damaging effects on the markets, essentially allowing energy and other commodity traders to set up huge, unregulated hedge funds within their corporate shield. For this reason, any attempt to set a statutory definition of *bona fide* hedging must be painstakingly developed to ensure that it is not overly broad.

Updating the SRO Model

The catastrophic failure of CME to monitor or oversee MF Global makes it clear that the era of self-regulating futures exchanges has run its course.[48] The conflicts of interest inherent in allowing an organization that depends on trade volume for revenues to police the members that provide that volume are simply too powerful to ignore. The expansion of the futures markets over recent years, as well as the recent "re-

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[46] PSI Report, at 103.

[47] See, for example, letters from FIA and API

[48] Protess, B., and Ahmed, A., MF Global Inquiry Turns to Its Primary Regulator (January 5, 2012), *available at* http://dealbook.nytimes.com/2012/01/05/mf-global-inquiry-turns-to-its-primary-regulator/.

futurization" wave that is bringing swaps onto DCMs like CME by replacing them with economically equivalent futures contracts means the stakes are higher than ever.

The over-broad discretion granted to the exchanges has also been abused, as recently demonstrated by the decision of the Intercontinental Exchange ("ICE") to set block trade thresholds so low for their newly "re-futurized" energy contracts that the **majority** of the market now trades as blocks – a designation that is meant to exempt only a small portion of extremely large trades from transparency requirements due to their potential to move markets.[49] This undercuts one of the primary rationales for exchange trading: transparency, which leads to a fair market with useful price discovery for all participants, not a select few who may take advantage of the many. Put another way, the opaque, unregulated OTC market is being revived under the guise of setting a block trade threshold. While there is nothing wrong with "re-futurization" *per se*, the opaque manner in which it has been effectuated is deeply problematic, done to further narrow self-interest, and improperly opens arbitrage opportunities.

Dodd-Frank was designed to bring futures-like transparency to swaps, not OTC-like opacity to DCMs.

The decision to do this was enabled by ICE's privileged "self-regulating" status. This outdated SRO model is no longer suitable in a day and age where so much profit is at stake due to the newly opened up swaps markets. This is especially true since that profit is closely tied to instruments that were heavily implicated in the last financial crisis and could easily trigger the next one if they are not comprehensively and effectively regulated.

Too often, the SROs have proven that they are unwilling or unable to self-regulate to the requisite standards. This was clearly illustrated by the failure of the National Futures Association to adequately monitor Peregrine Financial, despite numerous audit irregularities and tip-offs that serious wrongdoing was occurring.

The fact is that allowing an industry to police its own members necessarily results in colossal conflict of interests. Therefore, the Committee should consider replacing the SRO model entirely with an oversight system where the markets are properly policed by an adequately funded CFTC.

Short of this approach, and at a minimum, the Committee should consider steps aimed at restructuring the current SRO framework. In the securities arena, FINRA was created from the consolidation of the NASD and NYSE Regulation in 2007, reflecting in part a recognition that greater uniformity in regulation between competing SROs would help avoid a regulatory race to the bottom. The Committee should analyze whether or not the consolidation has in fact avoided a regulatory race to the bottom and what other or different steps may be necessary.

Furthermore, the excessive power that the SROs enjoy today should be taken out of the exchanges themselves and replaced by an external entity with more modest

49 www.theice.com

authority, limited to licensing and data collection, with rule-making and enforcement left exclusively in the hands of the un-conflicted regulator.

The importance of reforming the SRO model in the derivatives space cannot be overstated. With the former OTC markets coming onto exchange-like venues, including the largest, systemically important SROs, incentives are changing at a pace that the outdated self-regulatory structure cannot keep up with. Whether the Committee ultimately decides that the self-regulatory arms of the large exchanges should be consolidated like FINRA, and whether their authority needs to be scaled back, is something that will depend on hearings and deliberations. But these and other options – including abolishing the SRO structure within the commodities space entirely – should be an important part of the Reauthorization review process.

Cost-Benefit Analysis

The CEA already requires the CFTC to conduct an appropriate amount of economic analysis when it promulgates rules so that markets, investors and taxpayers are properly protected.

While some have argued that the CFTC should be required to conduct an onerous cost-benefit analysis for every rule it promulgates, the Committee should firmly reject any such amendments to the CEA. It is noteworthy that the CFTC has done its analysis well for decades, but only now its analysis is under near-constant attack. This should be seen for what it is: yet another backdoor attempt to kill, gut, weaken, or frustrate financial reform.

When analyzing any attempt to increase the CFTC's economic analysis burden beyond what the agency already must shoulder, it is vitally important to remember the following core facts and principles:

(1) the CFTC already has a significant obligation to consider costs and benefits when it promulgates rules, in light of five factors enumerated in the CEA;

(2) over many years, the agency has successfully fulfilled that obligation while writing hundreds of rules, carefully protecting market participants and the public while enabling the futures markets to thrive; and

(3) imposing yet more obligations on the CFTC such as what is commonly referred to as "cost-benefit analysis" (but which is really "industry cost-only analysis") would greatly reduce its ability to protect the American people and the markets from excessive risk and another financial crisis as well as to carry out its regulatory mission and fulfill Congress's policy objectives.

1. *Under the CEA, the CFTC already has an obligation to consider costs and benefits, and for good reason, Congress deliberatley chose not to impose a duty to conduct cost-benefit analsyis.*

Under Section 15(a) of the CEA, the CFTC already has a clear statutory obligation to "consider" the costs and benefits of its discretionary actions as they relate to certain public interest factors.[50] Specifically Section 15(a) directs the agency, when promulgating a rule, to "consider the costs and benefits of the action of the Commission" and to evaluate those costs and benefits "in light of"—

(A) considerations of protection of market participants and the public;

(B) considerations of the efficiency, competitiveness, and financial integrity of futures markets;

(C) considerations of price discovery;

(D) considerations of sound risk management practices; and

(E) other public interest considerations. [51]

Congress's careful choice of words in Section 15(a) makes clear that Congress intended the CFTC to have broad discretion in discharging its duty.[52] In fact, unlike in many other statutes, Congress chose ***not*** to require the CFTC to quantify costs or benefits,[53] weigh them against each other,[54] or find that a rule will confer a net benefit before promulgating it.

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50 7 U.S.C. § 19(a).

51 7 U.S.C. § 19(a).

52 Better Markets has set forth a comprehensive analysis regarding the scope of Section 15(a) in the *amicus curiae* brief it filed in support of the CFTC in *ISDA v. CFTC,* Civil Action No. 11-cv-2146 (RLW) ("*Amicus* Brief") (*available at* http://bettermarkets.com/sites/default/files/Corrected%20Brief%20of%20Better%20Markets%20as%20Amicus%20Curiae%20in%20Support%20of%20Defendant%20CFTC%20Apr.%2030,%202012.pdf). In that case, representatives of industry challenged, *inter alia*, the CFTC's consideration of costs and benefits in connection with the position limits rule. *See also* Better Markets *amicus* Brief filed in another case challenging a different rule, *available at* http://bettermarkets.com/sites/default/files/ICI%20v.%20CFTC%20-%20Amicus%20Brief%20of%20Better%20Markets%20June%2025,%202012.pdf. In addition, Better Markets has written to the Office of Management and Budget ("OMB") opposing CFTC Commissioner Scott O'Malia's request that OMB review the cost-benefit analysis performed by the CFTC in connection with several recently finalized rules. Letter from Better Markets to Jeffrey Zients, Acting Director of OMB (Feb. 29, 2012) ("Letter to OMB"), *available at* http://bettermarkets.com/sites/default/files/O'Malia%20CBA%20letter%20to%20OMB.pdf. In the Letter to OMB, Better Markets makes clear that various executive orders and OMB guidelines requiring cost-benefit analysis are inapplicable to the CFTC's rulemaking.

53 *Cf.* 42 U.S.C. § 300g-1(b)(3) (imposing a duty on the Environmental Protection Agency to use analysis of specific factors including the "[q]uantifiable and nonquantifiable health risk reduction benefits," the "[q]uantifiable and nonquantifiable costs," and "[t]he incremental costs and benefits associated with each alternative."). Courts have repeatedly held that an agency need not quantify the costs and benefits of a rule when a statute does not require it. *See, e.g., FMC Corp. v. Train*, 539 F.2d 973, 978-979 (4th Cir. 1976) (finding that 33 U.S.C. §§ 1314(b)(1)(B), (b)(2)(B) and § 1316 do not require quantification of the benefits in monetary terms). In fact, the D.C. Circuit has explicitly recognized that an agency's "predictions or conclusions" do not necessarily need to be "based on a rigorous,

As discussed further below, the rationale for this flexible obligation in the law is clear: requiring the CFTC to conduct a resource intensive, time consuming, and inevitably imprecise cost-benefit analysis as a precondition to rulemaking would significantly impair the agency's ability to implement Congress's regulatory objectives. Moreover, the industry's desire to have its costs prioritized over all other costs (what they falsely refer to as "cost-benefit analysis") is not a legitimate reason to change the law.

2. The CFTC has faithfully adhered to its statutory obligation, and in so doing, has effectively regulated the futures markets while allowing them to flourish.

For years, the CFTC has adhered to the statutory standard in Section 15(a). The discretion afforded to the CFTC under that provision has allowed the agency the necessary leeway to promulgate ***effective*** regulations in an efficient manner, all without imposing undue burdens on the markets or market participants.[55] Indeed, the United States Court of Appeals for the District of Columbia Circuit recently confirmed that the CFTC's economic analysis obligation is limited, and that the agency has appropriately discharged its duty.

In *Inv. Co. Inst. v. CFTC,* [56] the plaintiffs challenged the CFTC's recently-adopted rule requiring registered investment companies trading in commodity interests (including swaps) to register with the CFTC as commodity pool operators. Among the plaintiffs' core arguments was that the CFTC had failed to conduct an adequate "cost-benefit analysis" when it promulgated the rule. The Court rejected this claim, holding that the agency's consideration of costs and benefits under the five statutory factors was adequate.[57] Furthermore, the Court made very clear that the CFTC's duty under Section 15(a) is fundamentally different from a quantitative cost-benefit analysis:

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quantitative economic analysis." *Am. Fin. Services Ass'n. v. FTC*, 767 F.2d 957, 986 (D.C. Cir. 1985); *see also Pennsylvania Funeral Directors Ass'n v. FTC*, 41 F.3d 81, 91 (3d Cir. 1994) (recognizing that "much of a cost-benefit analysis requires predictions and speculation, in any context," and holding that the "absence of quantitative data is not fatal").

54 Courts distinguish statutes which include language of comparison, requiring a cost-benefit analysis, and statutes which do not. *See Am. Textile Mfrs. Inst. v. Donovan*, 452 U.S. 490, 512 n.30 (1981); *Reynolds Metal Co. v. EPA*, 760 F.2d 549, 565 (4th Cir. 1985); *Weyerhaeuser Co. v. Costle*, 590 F.2d 1011, 1045 (D.C. Cir. 1978).

55 "The CFTC regulates a futures and options industry that increased from 250 million contracts in 2001to more than 2.5 billion contracts in 2011. The value of customer funds held in Futures Commission Merchants Accounts, during the same period, increased from $56.7 billion to more than $203.7 billion, and the value of these contracts is notionally estimated at $40 trillion. With the passage of the Dodd-Frank Act, the CFTC is tasked with regulating the swaps markets with an estimated notional value of approximately $300 trillion – roughly eight times the size of the regulated futures markets." CFTC*, President's Budget and Performance Plan: Fiscal Year 2013*, at 1 (Feb. 2012), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2013.pdf.

56 *Inv. Co. Inst. v. CFTC*, No. 1:12-cv-00612 (D.C. Cir. June 25, 2013)

57 *Id*. at 13.

> The appellants further complain that CFTC failed to put a precise number on the benefit of data collection in preventing future financial crises. But the law does not require agencies to measure the immeasurable. CFTC's discussion of unquantifiable benefits fulfills its statutory obligation to consider and evaluate potential costs and benefits . . . . Where Congress has required "rigorous, quantitative economic analysis," it has made that requirement clear in the agency's statute, but it imposed no such requirement here.[58]

3. Imposing a cost-benefit obligation on the CFTC would create an enormous obstacle to strong and timely rulemaking that protects the public interest.

First, and foremost, requiring the CFTC to conduct cost-benefit analysis would directly interfere with the implementation of Congress's regulatory priorities. The point is obvious and irrefutable with respect to any rulemaking that Congress has mandated. Not only is it unnecessary under the statute for the CFTC to consider the costs and benefits of actions mandated by Congress, it would also be fruitless to require the agency to do so, since the agency has no authority to second-guess, ignore, or countermand the directives of Congress on cost-benefit or any other grounds.

Indeed, by mandating a rulemaking, Congress necessarily has already weighed the costs and benefits, and the agency's role is simply to implement Congress's directive. To construe a statute otherwise would make it impossible for Congress to mandate a rulemaking because all such rules would nonetheless be subject to some form of economic or cost-benefit analysis by an agency and, almost assuredly, by a court. That would violate the constitutional principles of separation of powers, subordinating Congress's legal powers to both the agencies and the courts.

Even as to the discretionary components of a congressional directive or grant of rulemaking authority, imposing a cost-benefit analysis standard would be extremely unwise. It would severely drain the CFTC's resources, delay its rulemaking process, and ultimately weaken the agency's ability to protect the public interest. In reality, cost-benefit analysis is an imprecise process, particularly in the field of financial regulation. While industry can identify and quantify the ***costs*** of regulation with relative ease, the task of measuring the **benefits** of regulation is much harder—even though the benefits may be enormous. Faced with such challenges, the CFTC would be forced to dedicate many more resources to the effort, and it could be expected to delay or even weaken many of its proposed rules based on stringent cost-benefit standards—not because the rules are unworthy or unnecessary, but because they cannot pass muster under the inherently imprecise cost-benefit test.

There can be no doubt that anyone seeking to thwart effective regulation of our commodities markets would eagerly and frequently invoke a cost-benefit analysis obligation in an effort to attack and invalidate rules as they are adopted by the CFTC. One need only look at the way opponents of financial reform have attempted to use

[58] *Id.* at 14-15 (cited authorities omitted).

Section 15(a), with its very limited economic analysis obligation, to attack rules. Indeed, even when the CFTC has clearly fulfilled its duty to consider the economic impact of its rules, industry representatives have challenged those rules claiming – without merit – that the CFTC failed to appropriately conduct what the industry calls "cost-benefit analysis." These attacks rest on a series of fundamentally flawed claims. For example, in challenging rules promulgated by the CFTC, the industry has:

(1) greatly exaggerated the actual duty imposed on the CFTC by its governing statute, Section 15(a) of the CEA, in effect seeking to transform that limited duty into an "industry cost-only analysis;"

(2) entirely disregarded the paramount statutorily required role of the public interest in the rulemaking process; and

(3) indefensibly ignored the enormous cost of the 2008 financial crisis and the larger collective benefit of all rules designed to help prevent a recurrence of that crisis or something far worse.

In reality, imposing cost-benefit analysis on the CFTC would be highly detrimental, all for no legitimate purpose. Simply put, there is no reason to prioritize minimizing cost to industry over the protection of the public interest in the commodities markets.

Indeed, when Congress drafted Section 15(a), it clearly intended to put the public interest ahead of all other concerns. The five factors that the CFTC must consider as specified in Section 15(a) reflect Congress's primary concern with the need for regulations that serve the public interest and accomplish the agency's mission, not with a need to spare industry the costs of regulation.

Without exception, each factor relates to a public benefit that arises from a robustly regulated marketplace, including preventing abuse, promoting competition, enhancing transparency, and limiting systemic risk.[59] Tellingly, none of the factors listed in the statute mentions any industry-focused concerns, such as compliance costs or the feasibility of conforming to rule requirements.[60] Removing any doubt, the fifth and final factor in Section 15(a) requires the CFTC to consider generally "any **other public interest** considerations."[61]

Finally, imposing a strict cost-benefit standard on the CFTC would prevent it from advancing the single most important "public interest consideration," which is completing the collection of reforms that Congress passed to provide for a safer and sounder

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59 7 U.S.C. § 19(a)(2).

60 *Cf.* 42 U.S.C. § 300g-1(b)(3)(C) (requiring analysis of certain costs of safe drinking water regulations including costs that "are likely to occur solely as a result of compliance with the maximum contaminant level, including monitoring, treatment, and other costs"); 42 U.S.C. § 6295(d) (1976 ed., Supp. II) (requiring a weighing of the economic impact on manufacturers and the savings in operating costs as "compared to any increase in the price of, or in the initial charges for, or maintenance expenses of, the covered products which are likely to result").

61 7 U.S.C. § 19(a)(2)(E) (emphasis added).

financial system and to prevent another financial crisis. The CFTC must consider the costs and benefits of any proposed rule implementing financial reform in light of the overarching goals of the Dodd-Frank Act. Those goals include preventing another financial collapse and economic crisis, including trillions of dollars in financial losses and incalculable human suffering.

The dollar cost alone of the financial collapse and still-unfolding economic crisis is conservatively estimated to be in the trillions. A study by Better Markets estimates that those costs will exceed $12.8 trillion. [62] In addition, the Government Accountability Office recently issued the results of a study on the costs of the crisis, finding that "the present value of cumulative output losses [from the crisis] could exceed $13 trillion."[63] Therefore, as the CFTC assesses the costs and benefits of proposed rules under Section 15(a), it must continue to consider, above all, the benefits of the entire collection of reforms embodied in the Dodd-Frank Act, of which any specific rule is but a single, integral part. The rigid, narrow, and quantitative requirements of cost-benefit analysis preclude this all-important holistic approach to rulemaking.

Congress passed the Dodd-Frank Act knowing full well that it would impose significant costs on industry, yet it determined those costs were not only justified but necessary to stabilize our financial system and avoid another financial crisis. Those costs include the elimination of extremely profitable lines of business as well as significant and ongoing compliance costs. A leading example is the establishment of the new, comprehensive regulatory regime for swaps. It will require the financial industry to incur significant costs arising from new personnel and technology, ongoing compliance, margin and collateral, and reduced revenues and profits.

However, the financial reform law and the rules implementing it do not, in fact, add any incremental costs (or, if they do, those costs are *de minimis*). Rather, they reallocate costs so that industry bears them in a regulated environment that **prevents** financial failure and bailouts. As a result, the public and society are spared the massive costs of responding to economic crises after the fact.[64]

Congress fully understood this. It knew that re-regulation would impose costs on the industry, in some cases totaling billions of dollars. The Dodd-Frank Act reflects Congress's unflinching determination to shift the costs of de-regulation and non-regulation of the financial industry back to the industry from a society that has paid and continues to pay the bill for industry's unregulated excesses. In substance, Congress conducted its own cost-benefit analysis and concluded that the enormous collective

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62 *See* BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis.pdf.

63 U.S. GOVERNMENT ACCOUNTABILITY OFFICE, FINANCIAL REGULATORY REFORM: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT, GAO-13-180, at 17 (Jan. 2013) (released Feb. 14, 2013), *available at* http://gao.gov/assets/660/651322.pdf.

64 *See* BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC, at 39-44 (July 30, 2012), *available at* http://bettermarkets.com/sites/default/files/CBA%20Report.pdf.

benefits of the law far exceeded the costs and lost profits that industry would have to absorb.[65]

Against the backdrop of the worst financial and economic crises since the Great Depression, it is inconceivable that Congress would enact sweeping reforms and then allow the implementation of those reforms to hinge on the outcome of a biased cost-benefit analysis that ignored the overriding purpose of the new regulatory framework—and that gave controlling weight to cost concerns from the very industry that precipitated the crisis and inflicted trillions of dollars in financial damage and human suffering across the country.

65 *Id.* at 43.