INSTITUTE FOR AGRICULTURE AND TRADE POLICY

Comment in response to the Joint Public Roundtable on International Issues Relating to the Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act
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General comment
IATP was unable to attend the Joint Roundtable on August 1, 2011 that is the occasion for this request for comments by the Commodity Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC). However, in reading the Joint Roundtable transcript, we believe that much of the discussion focused on the following provision of the Dodd-Frank legislation from Section 722:

''(i) APPLICABILITY.—The provisions of this Act relating to swaps
that were enacted by the Wall Street Transparency and Accountability
Act of 2010 (including any rule prescribed or regulation
promulgated under that Act), shall not apply to activities outside
the United States unless those activities—
''(1) have a direct and significant connection with activities
in, or effect on, commerce of the United States; or
''(2) contravene such rules or regulations as the Commission
may prescribe or promulgate as are necessary or appropriate
to prevent the evasion of any provision of this Act that was
enacted by the Wall Street Transparency and Accountability
Act of 2010.''.

First, we wish to draw attention to the phrase "commerce of the United States" in the provision above. In press articles and sometimes even in regulatory discussions of the problems of financial and commodity market regulatory harmonization among jurisdictions, there is a tendency to conflate the interests of major swaps dealers and major swaps participants with that of the entirety of "U.S. commerce." The denial by majors swaps dealers that financial speculation has had <u>any effect</u> on commodity prices and price volatility forms part of the putative evidence against the CFTC's proposed regulations and the harmonization of those

regulations in other jurisdictions.[1] IATP, together with more than a dozen non-governmental organizations, wrote to IIF to criticize their paper and challenge it to produce recommendations for the G-20 financial ministers based on the history of speculation during the past decade, rather than a denial of the existence of excessive speculation.[2]

To what extent has U.S. government support for rescuing the financial services industry been directed outside of the United States and to what extent has that support benefited U.S. commerce? Recent revelations about the extent of Federal Reserve Bank emergency loans to European subsidiaries of U.S. financial firms indicate that economic activities in Europe greatly affected the consolidated accounting books of the rescued U.S. firms. Half of the Fed's $1.2 trillion rescue package in October 2008 went to "European banks," many of them the European subsidiaries of U.S. firms.[3] (The ten largest U.S. banks and brokerage firms benefited from $669 billion in recently disclosed Federal Reserve Bank emergency loans in 2008 alone.) In view of the difficulties that commercial firms have had in accessing credit from these taxpayer recapitalized financial firms, it would be difficult to view the interests of "U.S. commerce" and of major swaps dealers as coterminous.[4]

Major swaps dealers and their political backers warn regulators about "significant competitive disadvantages" for them and major swaps participants if regulators implement Title VII of Dodd-Frank in advance of derivatives reform legislation in other jurisdictions, chiefly those of European Union member states. The small percentage of the notional value of derivatives trades that would be posted as initial margin for traders that would seek exemption from the general clearing requirement of Dodd-Frank constitutes much of the alleged "significant comparative disadvantage."[5] Migration of trade and indeed of trading firms "elsewhere" is threatened due to a projected loss of sales[6], above all for the five firms that control more than 95 percent of the U.S. derivatives market, accordingly to a recent report by the Office of the Comptroller of Currency.[7]

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[1] "Financial Investment in Commodity Markets: Potential Impacts on Commodity Prices and Volatility: IIF Commodities Task Force Submission to the G-20," International Institute for Finance, September 12, 2011. http://www.iif.com

[2] http://www2.weed-online.org/uploads/letter_iif_sep_2011.pdf

[3] Bradley Keoun and Phil Kunz, "Wall Street Aristocracy Got $1.2 Trillion in Secret Loans," Bloomberg, August 22, 2011. http://www.bloomberg.com/news/2011-08-21/wall-street-aristocracy-got-1-2-trillion-in-fed-s-secret-loans.html

[4] "Opportunities Exist to Strengthen Policies and Processes to Manage Emergency Assistance," General Accountability Office, July 2011. http://sanders.senate.gov/imo/media/doc/GAO%20Fed%20Investigation.pdf

[5] E.g., Tom Braithewaite, "New York lawmakers warn Bernanke over derivatives rules," *Financial Times*, May 18, 2011.

[6] E.g., Patrick Jenkins and Megan Murphy, "Goldman in Europe warning," *Financial Times*, September 30, 2010.

[7] http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq211.pdf

Indeed, the financial service industry has warned even Heads of State that economic growth will be endangered if new derivatives rules are implemented and enforced before the next election.[8] How should the CFTC (and SEC) respond to such threats and warnings in the context of their statutory obligations and the current crisis of macro-economic management?

Commodities are only about one percent of the total derivatives universe in notional value. The systemic risk posed by financial "innovations", such as High Frequency Trading, originally designed for interest rate and foreign exchange arbitrage, may therefore seem small when they are applied to commodities. However, a recent United Nations Conference on Trade and Development report notes, "The fact that monetary policy reacts to pressure stemming from rising commodity prices, rather than to bottlenecks in industrial production, points to a worrisome aspect of financialization [of commodities markets] that has so far been underestimated, namely its capacity to inflict damage on the real economy as a result of sending the wrong signals for macroeconomic management."[9] The damage to the real economy by prices driven in part by excessive speculation has been widespread, as the CFTC well knows from testimony to its agriculture and energy markets advisory committee meetings and comments received during Dodd-Frank rulemaking. As the CFTC and the SEC face the barrage of complaints and claims about "significant competitive disadvantage" posed by Dodd-Frank implementation, IATP hopes that both agencies will balance the costs to the financial services industry under Dodd-Frank implementation against the costs of continued macroeconomic management failures, due in part to deceptive signals to investors and regulators from commodity prices distorted by excessive speculation.

In search of the mythical "level playing field"

One leitmotif expressed by discussants at the Joint Roundtable was the need for a "level playing field" of rules that would apply equally to U.S. headquartered and non- U.S. headquartered entities.[10] The focus on an entity basis, rather than a trading practice basis, for defining the terms of international regulatory cooperation has lead global entities to raise questions about extra-territorial application of swaps rules. Those global entities raise the specter of unfair enforcement resulting from conflicting rules in the multiple jurisdictions where they and their subsidiaries trade.[11]

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[8] George Parker, "City pressure to delay bank revamp sways UK premier," *Financial Times*, September 2, 2011.

[9] "Price Formation in Financialized Commodity Markets: The role of information," United Nations Conference on Trade and Development, June 2011, 36.

[10] "Public Roundtable on International Issues Relating to the Implementation of Title VII of the Dodd Frank Wall Street Reform and Consumer Protection Act," (Transcript) August 1, 2011, Commodity Futures Trading Commission and Securities Exchange Commission, at 108. http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission21_080111-trans.pdf

[11] E.g., Aline van Duyn, "'ET' stokes fears about sweeping swaps rules," *Financial Times*, May 4, 2011.

The “level playing field” ideal comprises both a temporal component and substantive component. The temporal ideal is that all rules in all jurisdictions should be implemented simultaneously so that market participants would not be disadvantaged. The substantive ideal is that all rules should have the same content so that global entities would have legal certainty. The August 1 panel participants recognized that these ideals could not be realized. Nevertheless, there was a strong nostalgia for these ideals even though continuing to focus on them would not enable regulators to develop a process for regulatory cooperation and harmonization among jurisdictions. For example, to ensure legal certainty, one participant proposed that there be no regulatory overlap for global entities operating in multiple jurisdictions: “I think one important guiding principle should be that if you're subject to regulation elsewhere, you shouldn't be subject to the U.S.'s regulatory regime as well.”[12]

We disagree strongly with this belief that global entities whose trading strategies and practices arbitrage multiple jurisdictions and that keep consolidated accounting books should not be subject to overlapping regulatory regimes. Section 720 of Dodd-Frank anticipates that conflicts may arise from overlapping rules in jurisdictions and provides that a Memorandum Of Understanding (MOU) specify how such conflicts should be resolved. Consider, for example, how CFTC and forthcoming European Securities and Markets Authority rules to aggregate spot limits across exchanges and swaps execution facilities might conflict. How might the CFTC ensure that an aggregate position limits rule would not be circumvented by a foreign subsidiary of a major swaps dealer seeking to trade in CFTC regulated markets?

Challenges to negotiating a transatlantic memorandum of understanding: the example of aggregate position limits

To harmonize substantive rules, differences in rules, jurisdictional arrangements and regulatory implementation capacity need to be assessed. Only after such an assessment can a MOU be negotiated that would begin to satisfy the Dodd-Frank requirement of “comparability” of regulatory regimes for Foreign Board of Trade access to U.S. markets (Sec. 722), while recognizing the differences of foreign commodity market regulation with those of the CFTC. As regards aggregate position limits, negotiating a MOU that enables the comparability of regulatory regimes required by Dodd-Frank while acknowledging differences in the CFTC and European regulation of commodity markets, poses at least three noteworthy challenges.

First, there are currently no European-wide equivalents of the Commitments of Traders and other trade data reports used by the CFTC to do market surveillance. Instead, under proposed European legislation, national authorities would continue to regulate markets, and do market surveillance of both exchange traded data and swaps trade depository data in their jurisdictions. Because there is no European commodity market regulatory authority (despite the August 2010 French government proposal to create such an agency), the European Securities and Markets Authority (ESMA) will have a coordinating role, with some supervisory powers, among the member state authorities, to ensure that there is consistent trade data surveillance and rule enforcement. If there is a conflict in how the CFTC and ESMA enforce an aggregate position limit rule that applies to entities trading in both U.S. and EU jurisdictions, part of that conflict likely will concern EU member state capacity to do data surveillance that is comparable to how the CFTC does data surveillance. While the CFTC will not be authorized to audit EU exchange or

[12] Transcript, at 29.

swaps execution facility data, the MOU will need to contain criteria of comparability concerning EU and U.S. accuracy and completeness of trade data reporting demanded of exchanges and, in the near future, of swaps execution facilities. To some extent, the CFTC may be able to help develop such common criteria through its participation in the Technical Committee on Commodity Markets of the International Organization of Securities Commissions.

A second challenge in judging comparability of U.S. and EU oversight of an aggregate position limits rule will, of course, concern the definition of the rule itself. The spot month and conditional spot-month limit components of aggregate position limits for referenced contracts very likely will differ among U.S. and EU jurisdictions, because of difficulties in collecting historical trade data among the EU member state authorities as a basis for proposing spot and conditional-spot month limits for referenced contracts. Furthermore, the referenced contracts themselves will differ among the markets overseen by the CFTC and European authorities. Whatever technical standard ESMA writes to guide EU member states authorities to set and enforce position limits will become an issue in the regulatory conflict resolution procedure proposed in the transatlantic MOU.

A third challenge for CFTC negotiators of the MOU will be how any U.S. or EU exemptions, exclusions or waivers will affect the determination of whether the U.S. and EU regulatory regimes are comparable under Dodd-Frank. For example, if the CFTC derivatives end-user exemption from clearing were to encompass not just commercial risk hedged in referenced contracts but all financial risk of registered trading entities, such a broad exemption could not be comparable with EU exemptions, e.g., from clearing for Small and Medium-sized Enterprises. Would a broadly interpreted clearing exemption impede accurate surveillance of position limits across jurisdictions, and hence make comparability of enforcement of aggregate position limits exceedingly difficult? Comparing the major features of regulatory regimes for purposes of designing an MOU framework for resolving conflicts among rules likely will be challenging. Given the numerous exemptions, exclusions and waivers from rules that have been sought from both the Dodd- Frank and the EU derivatives legislation, it is more likely that harmonizing exemptions, exclusions and waivers will be more difficult than harmonizing substantive rules.

Conclusion

IATP does not believe that the challenges to harmonization of substantive rules sufficient to satisfy Dodd-Frank comparability requirements, exemplified above, are insurmountable. We strongly prefer an MOU for negotiating differences on substantive rules and their implementation to the negotiation of a Mutual Recognition Agreement that recognizes regulatory regimes as comparable without an auditing procedure for reviewing the implementation of major rules in the covered jurisdictions. We do believe however, that to negotiate and monitor robust MOUs, new configurations of international regulatory cooperation will be needed beyond what the CFTC currently practices. While the negotiation of an MOU is clearly a CFTC responsibility, monitoring of whether foreign regulatory bodies meet Dodd-Frank comparability criteria requires feedback from a broad array of market participants.

For example, the composition of the Global Markets Advisory Committee that advises the CFTC's international office consists almost entirely of representatives of the financial services industry, supplemented occasionally with visitors from foreign governments. The trading practices of global entities affect not just global entities but commercial hedgers both inside and

outside the United States. To be better advised of the international consequences of CFTC rules, the CFTC should include representatives of those hedgers on GMAC and should solicit their testimony. Given the budgetary pressures on the CFTC, the use of webcasting should be expanded to include the testimony of foreign regulators, of officials from relevant intergovernmental organizations, and commercial hedgers outside the United States.

IATP wishes to thank the CFTC (and the SEC) for offering a broadly defined opportunity to comment on problems that may arise in harmonizing CFTC and SEC rules with the rules and technical standards promulgated by foreign governments. We have focused on those rules that will begin to implement the European derivatives directives as they are adopted into EU member states legislation in 2013. Given the complexity of this enterprise, IATP hopes that the CFTC will hold further roundtables and public meetings on international issues in commodity market regulation. IATP greatly appreciates the efforts that the CFTC has made to explain Dodd-Frank and CFTC rulemaking to foreign officials.