



Some impediments to fulfilling G-20 economic governance commitments with examples of U.S. opposition to regulation affecting commodity markets

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“The more competition comes into the trading of derivatives, the smaller the profits for the current big traders will be. The entire food chain of the derivatives markets could be rearranged.”

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Abstract: The financial services industry opposition to financial and commodity market reform, supported by some elements of the U.S. government, raises doubt about the likelihood of effective oversight recommendations by the Group of 20 (G-20) financial ministers for the Heads of State summit in November in France. This overview focuses on two regulatory issues that affect commodity markets directly: aggregate limits to the numbers of contracts that can be held by one entity during a trading period (“position limits”) and proposed exemptions to ‘pushing’ over-the-counter (OTC, i.e., unregulated, bilateral) derivatives trades on to regulated exchanges. The recent decision of the U.S. Department of Treasury to exempt OTC foreign exchange derivatives from the Dodd-Frank requirements is briefly mentioned, insofar as that exemption may have consequences for the physical and futures market commodity trades that are often denominated in U.S. dollars. Furthermore, analytic differences among the intergovernmental agencies advising the G-20 financial ministers may result in ineffectual commitments to address commodity price volatility. The second part of this input paper surveys some impediments to strong G-20 commitments on commodity market regulation.

1. The G-20 Heads of State have made commitments that affect commodity derivatives, i.e., futures, options and swaps (of the cash flows of futures or options) contracts whose value is derived from that of an underlying asset, e.g., oil or wheat:

All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. . . . We have agreed to improve the regulation, functioning and transparency of financial and commodity markets to address excessive commodity price volatility.²

This is a commitment to a huge task: moving unregulated and opaque OTC trades onto regulated and transparent exchanges or electronic trading platforms.

2. According to the Bank of International Settlements, as of December 2009, OTC bilateral (no exchange intermediary) trades comprised 89 percent of all derivatives trades.³ Characteristics of these trades include: no timely and transparent reporting of trade data; no centralized clearing (essentially, sound credit management practices) to protect against defaults among the parties to a trade; and claims that the bilateral trades were so “customized” to the needs of counterparties that they couldn’t be standardized (e.g., in standardized volume of a commodity, standardized contract language etc.) for exchange trading. A February report of the

International Organization of Securities Commissions (IOSCO) leads one to surmise that the G-20 commitment to standardizing OTC derivatives leaves open a lot of room for the customized contracts of financial “innovation,” since “there is no definitive boundary between products with sufficient standardization to be traded on an organized platform and those that lack such standardization.”⁴ These three regulatory deficiencies were among the critical factors leading to the financial services industry crisis of 2008 that instigated the G-20 Heads of State commitments.

3. The Financial Stability Board (FSB), in its April 2011 report to the G-20 financial ministers meeting, doubted whether the end-2012 deadlines for fulfilling the Heads of State commitments would be kept. Causes of doubt included the pace of implementation of rules among different jurisdictions, the disparities in the content of rules, particularly regarding how trade data are to be reported, and the jurisdictional differences of the proposed credit management practices and ownership rules for clearing houses.⁵ As is customary among international agency reporting, no particular jurisdiction is singled out for criticism. However, since OTC risks are often hedged on exchanges, and more than 93 percent of standardized derivatives were transacted in U.S. or European markets,⁶ a good portion of the resistance—and not just on the FSB-cited issues to completing the G-20 mandated reforms—resides in those jurisdictions. The likelihood that regulatory harmonization among jurisdictions will neither be total nor simultaneous is given as a reason by the financial industry for delaying implementation of regulatory reforms in both U.S. and EU jurisdictions, alleging a competitive disadvantage for first movers to regulation. Below we summarize some of the U.S. opposition to financial and commodity market reform.
4. Opposition to implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in commodity markets has taken many forms. Republican Party Congressional tactics have ranged from proposing “technical corrections” to the bill to reverse reform,⁷ to delaying implementation (except for a few provisions) until September 2012 and creating new broad authority for regulatory exemptions. Spencer Bachus, U.S. House of Representatives finance committee chairman, justified the bill to delay implementation (HR 1573), stating “This bill will ensure that the United States is not placed at competitive disadvantage compared to the rest of the world” by implementing regulation in advance of other jurisdictions, particularly those of the European Union.⁸ The first House bill to cut CFTC funding 34 percent so that it cannot implement Dodd-Frank⁹ was made moot by a temporary budget compromise engineered by President Obama and the Congressional leadership. A new bill would cut 13.4 percent cut from 2011 fiscal year levels, about 22 percent less than the CFTC funding requested by the Obama administration.¹⁰
5. There is bipartisan Congressional support for exempting OTC commodity derivatives from having to post margin collateral (usually, 4–8 percent of the total transaction cost of the trade) in order to trade. Proponents promote the exemption to favor OTC trades over trades on regulated exchanges, which require margin payment. They claim the exemption will protect the competitiveness of U.S.-headquartered transnational firms against their foreign affiliates and other firms. The end user exemption is also justified as a means to conserve working capital for investments to create U.S. jobs, which has yet to occur despite the economists’ claims of a U.S. economic “recovery.”¹¹

6. The financial services industry and their biggest derivatives customers may take a legal challenge to the authority of the CFTC to set position limits all the way to the U.S. Supreme Court. Notwithstanding the Congressional mandate in Dodd-Frank to set position limits, industry lobbyists argue that to set limits, the CFTC must first demonstrate that excessive speculation has occurred and damaged interstate (U.S. federal states only) commerce as a result. The lobbyists (and at least two of five CFTC commissioners) argue that there is no “hard data” to show that excessive speculation occurred, and therefore, the CFTC (and by extension, the Congress) has no authority to set position limits.¹²
7. The CFTC is unlikely to be intimidated by the threat of such a lawsuit. However, industry may use the lawsuit to cast doubt on the legal certainty of Dodd-Frank, which would have international consequences for the application of Dodd-Frank for Foreign Boards of Trade (FBOTs) seeking direct access to U.S. markets. To qualify for such direct access, FBOTs must be “subject to comparable, comprehensive supervision and regulation by the appropriate governmental authorities in the FBOT’s home country.”¹³ An industry strategy to delay Dodd-Frank implementation with an appeal to the U.S. Supreme Court would succeed politically if the delay allowed a new Republican-controlled Congress and presidency in 2013 to repeal Dodd-Frank. As ever, derivatives industry lobbyists charge that the “extra-territoriality” of Dodd-Frank provisions or the legislation of any other jurisdiction will “force” global firms to leave U.S. (or EU) markets to trade in the weakest regulatory jurisdiction.¹⁴ In sum, markets may be extra-territorial but regulation must not be.
8. The April 29 decision by U.S. Secretary of Treasury Timothy Geithner to exempt foreign exchange derivatives from Dodd-Frank requirements likely will exacerbate commodity price volatility. The U.S. Treasury justified the exemption by claiming that foreign exchange markets performed well during the 2008 financial industry crisis that triggered the ongoing global economic recession.¹⁵ According to the U.S. Treasury, there was no need to regulate further instruments that had provided liquidity during the crisis. However, as Better Markets Inc. (a U.S.-based NGO) pointed out in a February 25 letter to Secretary Geithner, on the basis of a Dodd-Frank–mandated release of Federal Reserve Bank data, “the Fed had to bail out the foreign exchange markets with \$2.9 trillion in October 2008 alone [...] the Fed’s emergency intervention stopped the market’s death spiral.” The foreign exchange bailout to U.S. and non-U.S. firms was a 4000 percent increase over the pre-crisis Federal Reserve Bank support for foreign exchange trading.¹⁶
9. UNCTAD and other relevant intergovernmental agencies will be challenged to analyze the extent to which dark market foreign exchange trading exacerbates commodity revenue volatility in dollar denominated contracts. Since there is no real economic rationale for the U.S. foreign exchange regulatory exemption, a geo-political analysis may usefully supplement the academic analysis of U.S. foreign exchange policy and its effects on commodity export revenues and import costs. Brazil has proposed a World Trade Organization (WTO) discussion on exchange rate volatility and trade revenues in the Working Group on Trade, Debt and Finance.¹⁷ Notwithstanding the World Bank’s projection of a multi-currency international monetary system, no longer dominated by the U.S. dollar, in the near future,¹⁸ foreign exchange regulation and its impact on trade revenues will remain a contentious issue. The issue of currency “manipulation” and foreign exchange trading practices is very likely to be raised by Brazil and other WTO members in these discussions.

10. The U.S. opposition to commodity market regulation, summarized in part above, will likely present impediments to strong commitments from G-20 finance ministers to regulate commodity markets. For example, a G-20 commitment to ensure that there are sufficient budgetary, technical and human resources to do market data surveillance and enforce regulations seems unlikely at this point.¹⁹ Insofar as G-20 recommendations are decided by consensus, the advisory process that informs financial minister recommendations to the Heads of State will not take up issues where strong opposition is perceived among some G-20 members and/or from agencies in the advisory process for the G-20 financial ministers. The advisory process comprises inputs from an interagency paper requested by the financial ministers, the aforementioned IOSCO and FSB inputs and a report from a commodity markets study group lead by Japan.²⁰
11. We conclude by reviewing issues raised in the interagency paper and challenges faced by the study group as it prepares its report for the October 14–15 financial ministers’ meeting. In November 2010, the G-20 Heads of State requested a paper on agricultural and commodity price volatility from eight intergovernmental agencies.²¹ The G-20 leaders’ mandate was “to develop options for G20 [sic] consideration on how to better mitigate and manage the risks associated with the price volatility of food and other agriculture commodities, without distorting market behavior, ultimately to protect the most vulnerable.”²² Probably the most problematic clause in the mandate is “without distorting market behavior,” since the correlated price volatility of unrelated agricultural and non-agricultural markets, as documented by UNCTAD, already indicates a disorderly and distorted market.²³ Some initiatives that might make the market less distorted, such as a G-20 commitment on positions limits, remain controversial among the agencies that maintain excessive speculation has not been and is not a commodity price driver.
12. The interagency agreement to launch a Joint Operational Data Initiative (JODI) corresponds to widespread recognition that knowledge of physical stock holdings is woefully lacking. This welcome decision to attempt to determine the supply in the supply-demand relation that is supposed to be the basis for commodity price formation faces steep hurdles—not the least of these hurdles, as noted by Brazil,²⁴ is that the privatization of stocks as Confidential Business Information means accurate physical stocks information will be difficult to come by. The JODI will have to develop some way to better estimate stocks than currently exists since the firms that control physical supply are not likely to turn over actual data to the JODI.
13. Finally, one issue that none of the G-20 input streams has addressed is the High Frequency Trading (HFT) of commodities via so-called trading algorithms. The May 2011 commodity price collapse was partly driven by commodity index funds bet “long,” i.e., to increase in price, that were traded according to HFT “algos.”²⁵ While the May 26, 2010 HFT “flash crash” has been the object of CFTC study, no G-20 policy options have been proposed to regulate a trading practice that has distorted the market for commercial hedgers in commodity markets.

¹ Cited in Aline van Duyn, “Battle lines emerge as new rules are created,” *Financial Times*, May 31, 2011.

² Group of 20 Summit, September 2009, U.S. Chair’s Progress Report, at 12.

³ “Report on Trading of OTC Derivatives,” International Organization of Securities Commissions, February 2011, 4, <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD345.pdf>.

⁴ *Ibid.*, 25.

⁵ “Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability,” Report of the Financial Stability Board to the G20 Financial Ministers and Central Bankers, April 10, 2011, 5.

⁶ “Report on Trading of OTC Derivatives,” *op. cit.*, 7.

⁷ Maya Jackson Randall and Jessica Holzer, “Dodd-Frank Foes Adopt New Tactics,” *Wall Street Journal*, April 7, 2011.

⁸ “Key House Lawmakers Introduce Bill to Extend Deadline for Derivatives Title of Dodd-Frank,” U.S. House of Representatives Committee on Agriculture, press release, April 15, 2011, <http://agriculture.house.gov>.

⁹ Ben Protess, “Regulators Decry Proposed Cuts In C.F.T.C. Budget,” *The New York Times*, February 22, 2011, <http://dealbook.nytimes.com/2011/02/24/regulators-decry-proposed-c-f-t-c-budget-cuts/?ref=todayspaper>.

¹⁰ <http://farmpolicy.com/2011/05/26/farm-bill-trade-ag-economy-regulations-animal-ag-and-cftc/>

¹¹ Letter from Senator Debbie Stabenow, Chairwoman of the Senate Committee on Agriculture, Nutrition and Forestry, and Senator Tim Johnson, Chairman of the Senate Committee on Banking, and Representatives Frank Lucas, Chair of the Committee on Agriculture, and Representative Spencer Bachus, Chairman of the Committee on Financial Services to Secretary of Treasury Timothy Geithner, Chairman of the Federal Reserve Bank Ben Bernanke, Securities and Exchange Commission Chairwoman Mary Shapiro and Commodity Futures Trading Commission Chairman Gary Gensler, April 6, 2011, <http://agriculture.house.gov/pdf/letters/HouseSenateEndUserLetter.pdf>.

¹² John Kemp, “Position limits head for showdown in court,” Reuters, March 30, 2011. <http://www.commodities-now.com/news/general/5615-position-limits-head-for-showdown-in-court.html>.

¹³ “Proposed Rules Regarding the Registration of Foreign Boards of Trade,” Commodity Futures Trading Commission, http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/fbot_factsheet.pdf.

¹⁴ Aline van Duyn, “‘ET’ stokes fears about sweeping swaps rules,” *Financial Times*, May 4, 2011.

¹⁵ “Mr. Geithner’s Loophole,” *The New York Times*, April 30, 2011, and Gretchen Morgenson, “The Bank Run We Knew So Little About,” *The New York Times*, April 2, 2011.

¹⁶ “New Information on the Proposed Exemption of Foreign Exchange Swaps and Futures Show Collapse of Foreign Exchange Markets During Economic Crisis,” Better Markets, Inc., February 25, 2011, <http://www.bettermarkets.com/assets/pdf/FX-Ltr-Supp-2-25-11.pdf>.

¹⁷ Kanaga Raja, “Brazilian proposal on exchange rates discussed at WTO,” South-North Development Monitor (email edition), No. 7148, May 12, 2011.

¹⁸ *Multipolarity: The New Global Economy*, The World Bank, May 2011, <http://siteresources.worldbank.org/INTGDH/Resources/GDH-AdvanceEd-CompleteBook.pdf>.

¹⁹ Steve Suppan, “Multilateralizing G20 commitments on the commodity derivatives market: Two very modest proposals,” Institute for Agriculture and Trade Policy, April 27, 2010, <http://www.iatp.org/iatp/commentaries.cfm?refid=108001>.

²⁰ Bank of Japan Official to Lead G-20 Inspection of Commodities Prices,” Dow-Jones Wire, February 19, 2011, <http://www.dowjones.de/site/2011/02/bank-of-japan-official-to-lead-g-20-inspection-of-commodities-prices.html>.

²¹ “Price Volatility in Food and Agricultural Markets: Policy Responses,” United Nations Food and Agricultural Organization, International Fund for Agricultural Development, International Monetary Fund, Organization for Economic Cooperation and Development, World Food Program, World Bank, World Trade Organization, International Food Policy Research Institute, and U.N. High Level Task Force on Global food Security, May 3, 2011. <http://www.tradeobservatory.org/library.cfm?refID=108014>.

²² Ibid., 3.

²³ Most recently, *The Financial and Economic Crisis of 2008-2009 and Developing Countries*, UN Conference on Trade and Development and the Institut für Technik und Wirtschaft Berlin, March 2011, http://www.unctad.org/en/docs/gdsmdp20101_en.pdf.

²⁴ "Commodity Markets Volatility and Food Security: A Contribution by Brazil," February 24, 2011.

²⁵ Jack Farchy, "Nervy investors dump commodities," *Financial Times*, May 7-8, 2011.