

COMMODITY MARKETS OVERSIGHT COALITION

October 30, 2009

The Honorable Barbara Boxer, Chairman
The Committee on Environment & Public Works
United States Senate
401 Dirksen Senate Office Building
Washington, DC 20510-6175

The Honorable John Kerry, Chairman
The Committee on Foreign Relations
United States Senate
446 Dirksen Senate Office Building
Washington, DC 20510-6225

Dear Senators Boxer and Kerry:

The undersigned organizations are writing to underscore the need for derivative market reforms as your respective Committees advance climate change legislation that would create a system for “Pollution, Reduction, and Investment” (PRI), or otherwise known as “Cap-and-Trade.” It is not our coalition’s intent to express either support or opposition to S. 1733, *The Clean Energy Jobs and American Power Act of 2009*. Rather, we wish only to highlight the potential effects that carbon trading resulting from PRI market-based mechanisms and related financial instruments could have on the broader economy, overall market supply and demand fundamentals, and systemic financial integrity.

Our groups are concerned with the potential consequences of creating a PRI market-based carbon market without a preexisting, transparent, and comprehensive oversight and regulatory framework; and importantly, protections against fraud, manipulation and excessive speculation. If created, a comprehensive carbon trading market would be one of the world’s largest and most lucrative new commodities markets. According to the U.S. Commodity Futures Trading Commission (CFTC), by 2017, U.S. carbon markets could exceed \$2 trillion in nominal value.

As has become evident, the recent U.S. financial collapse was caused in part by a massive unregulated “side-bets” on the over-the-counter (OTC) derivatives markets and by extreme commodity price volatility and excessive speculation. While the CFTC is now considering major reforms within the existing markets in an attempt to prevent a repeat of the speculative bubbles that caused this crisis, additional Congressional authorities are required in order to close the existing loopholes in current futures and securities laws, and to extend existing rules and regulations to newly emerging markets, especially domestic and international environmental markets like carbon and offsets.

Work to strengthen and support derivatives regulations

Currently, Congress is debating a series of reform-minded proposals that would seek to return to the CFTC its authority over OTC swaps and derivatives markets. The bill (H.R.3795) recently passed out of the House Financial Services Committee, while an attempt at some measure of reform, fails to close certain loopholes and has the potential to create new ones. For example, the CFTC currently bars most OTC swaps in agricultural commodities unless expressly approved in a transparent public process and hearing by the CFTC. This prohibition is regularly violated by commodities traders, and instead of assuring its implementation, Chairman Frank’s (D-MA) bill would remove the rule altogether. The bill also creates exemptions that could serve as loopholes for banks and hedge funds, and allows blanket exemptions for trading activity conducted off-shore.

The House Agriculture Committee also recently passed a bill (an amendment in the nature of a substitute for H.R.3795) that makes vital improvements to the Financial Services legislation, such as

requiring aggregate position limits across all markets, exchanges, and platforms. However, additional improvements would be necessary in order to assure complete market transparency and financial stability, and to prevent systemic risks posed by potential counterparty defaults. (See October 20, 2009 CMOC letter to Chairman Peterson, attached.) We continue to work with House members on solutions to improve this legislation as the process evolves.

However, we understand that not only is the financial services industry opposing needed reforms in the existing markets, but they are also resisting the extension of these reforms to new environmental trading and related derivative markets. Therefore, we urge you to proceed with caution when contemplating the creation and potential effects of a PRI or “cap-and-trade” system.

Robust carbon derivatives regulations are needed

Should Congress eventually pass climate change legislation establishing a national PRI or “cap-and-trade” program, the following elements must be included:

- *Mandatory exchange trading for all environmental trading activity:* All trading of emissions allowances, offsets, credits and related investment instruments and products, including options, swaps and derivatives, **should be standardized and conducted on open, transparent and regulated exchanges.**
- *Curb passive index investment:* Index funds and passive investors hold some 40% of open interest positions in various commodities, yet the funds do not provide liquidity or enhance the price discovery mechanism of the physical commodity – the index investment is simply “parked” in the commodity class. Since this kind of carbon hoarding would create excessive speculation and increase compliance costs for covered entities, **passive index funds and Exchange Traded Funds (“ETFs”) should be prohibited from participating in the trading of carbon.**
- *Require Comprehensive Study:* Moreover, **Congress should study how a rapidly expanding and volatile carbon market could impact energy, agricultural and other futures prices,** particularly if carbon contracts were bundled into commodity index funds. Such studies would help Congress determine how carbon derivatives markets should be supervised, and whether they provide reliable price signals to promote investments in carbon emissions reduction technology.

We thank you for your consideration. Please feel free to contact us if you have questions or if we can be of assistance in your efforts.

Sincerely,

Agricultural Retailers Association
Air Transport Association
American Feed Industry Association
American Trucking Associations
Colorado/Wyoming Petroleum Marketers Association
Consumer Watchdog
Florida Petroleum Marketers Association
Food and Water Watch

Friends Committee on National Legislation (Quakers)
Friends of the Earth
Grassroots International
Independent Connecticut Petroleum Association
Institute for Agriculture and Trade Policy
Louisiana Oil Marketers & Convenience Store Association
Maine Energy Marketers Association
Maryknoll Office for Global Concerns
Massachusetts Oilheat Council
Municipal Electric Systems of Oklahoma
National Association of Truck Stop Operators
Nebraska Petroleum Marketers & Convenience Store Association
New England Fuel Institute
New Rules for Global Finance
New York Oil Heating Association
Oil Heat Council of New Hampshire
Oil Heat Institute of Rhode Island
Organization for Competitive Markets
Petroleum Marketers Association of America
Petroleum Marketers & Convenience Store Association Kansas
Petroleum Marketers & Convenience Stores of Iowa
Propane Gas Association of New England
Public Citizen
R-CALF USA
Sisters of Notre Dame de Namur Justice and Peace Network
South Dakota Petroleum & Propane Marketers Association
Vermont Fuel Dealers Association

cc: The Hon. James Inhofe, Ranking Member, Senate Committee on Environment & Public Works
The Hon. Richard Lugar, Ranking Member, Senate Committee on Foreign Relations
The Hon. Blanche Lincoln, Chairman and The Hon. Saxby Chambliss, Ranking Member
U.S. Senate Committee on Agriculture, Nutrition and Forestry
The Hon. Chris Dodd, Chairman and The Hon. Richard Shelby, Ranking Member
U.S. Senate Committee on Banking, Housing and Urban Affairs
The Hon. Max Baucus, Chairman and The Hon. Charles Grassley, Ranking Member
U.S. Senate Committee on Finance
The Hon. Jeff Bingaman, Chairman and The Hon. Lisa Murkowski, Ranking Member
U.S. Senate Committee on Energy and Natural Resources
The Hon. Jay Rockefeller, Chairman and The Hon. Kay Bailey Hutchison, Ranking Member
U.S. Senate Committee on Commerce, Science & Transportation
The Hon. Gary Gensler, Chairman, U.S. Commodity Futures Trading Commission
The Hon. Michael Dunn, Commissioner, U.S. Commodity Futures Trading Commission
The Hon. Jill Sommers, Commissioner, U.S. Commodity Futures Trading Commission
The Hon. Bart Chilton, Commissioner, U.S. Commodity Futures Trading Commission

COMMODITY MARKETS OVERSIGHT COALITION

The Hon. Scott O'Malia, Commissioner, U.S. Commodity Futures Trading Commission

COMMODITY MARKETS OVERSIGHT COALITION

October 20, 2009

The Honorable Collin Peterson
Chairman, Committee on Agriculture
U.S. House of Representatives
1301 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

We write to again recognize you for your strong leadership in seeking to improve the transparency and strengthen regulatory oversight of our nation's commodity markets. We are convinced that inadequate regulation of these markets was the single most significant factor in the development of last year's energy and food commodity price bubbles, and that it contributed greatly to the severity of the larger economic downturn. You have been a leading voice in Congress on the need to address this issue through legislation and we are committed to working with you to see that a strong market reform bill is enacted into law.

We are supportive of H.R. 3795, the Over-the-Counter Derivatives Markets Act of 2009, which you introduced last week and thank you for the opportunity to share our views with you on that legislation. We have three suggestions for changes that we believe will strengthen the legislation.

First, we would like the Commodity Exchange Act to require the Commodity Futures Trading Commission (CFTC) to impose speculative position limits on all non-commercial traders of commodities across all markets, including the over-the-counter markets. Your bill would give CFTC the authority to take such action for "significant price discovery" contracts, which is a significant improvement over current law. However, we believe all contracts and all trades have an impact on price discovery and should be subject to position limits. This is probably the single most effective change in statute that could be made to ensure excess speculative money does not again flood into commodity markets – as it did last summer – and drive future economically devastating energy and food commodity price bubbles.

Secondly, we are concerned about the lack of specificity in the definition of a "Tier-1 financial holding company" in your legislation. While we understand that the Systemic Risk Regulator will make certain determinations as to who qualifies for such a designation, we feel the statute should be clear that all of the major holding companies in the U.S. be included in that definition. Thus, we suggest that you designate any financial holding company with assets above a certain threshold to be considered a Tier-1 financial holding company for purposes of the statute.

Finally, we encourage you to enhance the definition of "manipulation" in your legislation to ensure the CFTC is allowed to use the same prosecutorial standard as other federal regulatory agencies, such as the Securities and Exchange Commission, the Federal Energy Regulatory Commission, and the Federal Trade Commission. Current law requires the CFTC to meet a

more rigorous standard – a “specific intent” standard – to prove market manipulation than do other financial market regulatory agencies, which only have to prove an action was “reckless” to secure a prosecution. This inconsistency of standards makes it much more difficult for the CFTC to successfully prosecute manipulation and inadequately deters illegal behavior.

Again, we thank and commend you for your leadership on these vital issues and will continue to work with you to ensure that strong market reform legislation is enacted into law. Please feel free to contact us if you have questions or if we can be of assistance in your efforts.

Sincerely,

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Air Transport Association
American Feed Industry Association
Colorado/Wyoming Petroleum Marketers Association
Florida Petroleum Marketers Association
Friends of the Earth
Independent Connecticut Petroleum Association
Institute for Agriculture and Trade Policy
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Massachusetts Oilheat Council
National Association of Truckstop Operators
Nebraska Petroleum Marketers & Convenience Store Association
New England Fuel Institute
New York Oil Heating Association
Petroleum Marketers & Convenience Store Association Kansas
Petroleum Marketers & Convenience Stores of Iowa
Petroleum Marketers Association of America
Propane Gas Association of New England
Public Citizen
R-CALF USA
South Dakota Petroleum & Propane Marketers Association
Vermont Fuel Dealers Association

Cc: Then Honorable Frank Lucas, Ranking Member, House Committee on Agriculture