INSTITUTE FOR AGRICULTURE AND TRADE POLICY

Comment on "Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations: Proposed Rule" (17 CFR Parts 1, 20, 151)

Commodity Futures Trading Commission (CFTC)

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General comment on the release of the rule for public comment

The Institute for Agriculture and Trade Policy (IATP) is pleased and grateful that the CFTC has voted to release this Proposed Rule for public comment. IATP is a 501(c)3 nonprofit organization headquartered in Minneapolis, Minn., with offices in Washington, D.C. and Geneva, Switzerland.

On August 12, IATP submitted a comment for the CFTC hearings on the trading of energy and energy derivatives (i.e., exchange-listed natural gas, crude oil, heating oil and gasoline futures and options).[1] Our comment began by citing the following passage from the February 12, 2009 testimony of Dennis Blair, Director of National Intelligence to the Senate Select Committee on Intelligence: *"Time is probably our greatest threat. The longer it takes for the recovery to begin, the greater the likelihood of serious damage to U.S. strategic interests [...] Statistical modeling shows that economic crises increase the risk of regime-threatening instability if they persist over a one- to two-year period."* Given the year that has passed since Director Blair's testimony, and with due respect to the three CFTC Commissioners who expressed reservations about releasing this Proposed Rule for comment until Congress passes legislation to reform the over-the-counter (OTC) derivatives market and until the European Union member states have implemented similar legislation, time is not on our side. Rather than wait for Congress and foreign governments to begin to regulate effectively the financial and commodity markets whose regulatory exemptions, waivers and exclusions helped to trigger the ongoing economic crisis, the CFTC should lead by the example of implementing and enforcing this Proposed Rule.

The financial services industry is spending about $350 million to lobby for new exemptions, waivers and exclusions from U.S. regulation and legislation. That lobbying clout well may succeed in blocking urgently needed and overdue reforms.[2] The European Commission likewise faces industry opposition to its reform proposals[3] but nevertheless issued, on October 21, an ambitious and detailed work plan for OTC derivatives legislation for 2010.[4] As a pre-condition for implementing the Proposed Rule, the CFTC should not wait for Congress and the EU to pass legislation and then wait further for its implementation, to prevent the financial service industry's regulatory arbitrage and often-threatened migration of trades to non-U.S. markets. Indeed, as noted in the Proposed Rule, opponents of energy contract position limits cite "market

migration risk" and pushing price discovery to markets beyond CFTC authority as reasons to oppose all position limits (p. 4148, footnote 47).

However, there is ample analysis to prove the persistence of excessive speculation in energy contracts, with damage to both the price risk management capacity of physical hedgers and to the broader public, in the form of unwarranted price increases in heating oil, gasoline and other retail and wholesale energy products.[5] One analysis estimated that the 2008 commodities bubble enabled by lack of energy position limits and regulatory exemptions for other commodities cost the United States $110 billion.[6] Such evidence alone justifies the implementation of the Proposed Rule now.

Furthermore, the lack of energy trade position limits has exacerbated excessive speculation and price volatility in agricultural futures contracts bundled into energy-dominant commodity index funds. According to CFTC Commitment of Traders data, commodity index funds held about 42 percent of wheat futures contracts as of June 2008, 42 percent of live cattle, 31 percent of sugar and feeder cattle, 27 percent of corn, 26 percent of coffee and lesser shares of other agricultural commodities.[7] The June 24, 2009 U.S. Senate Permanent Subcommittee on Investigations report, "Excessive Speculation in Wheat Markets," concluded that index funds were major drivers of extreme price volatility in wheat markets.[8] Position limit exemptions for swaps dealers on agricultural contracts, arguably per se violations of the "Commodity Futures Modernization Act of 2000" (CFMA),[9] enabled huge "weight of money" disparities between index funds and physical hedgers.

For example, in March of 2008, the Goldman Sachs and Morgan Stanley index funds controlled 1.5 <u>billion</u> bushels of Chicago Board of Trade corn futures contracts, while physical hedgers were position limited to controlling 11 <u>million</u> bushels.[10] One CFTC Commissioner compared such "weight of money" market dominance to that of a new player who lays down a hundred dollar bet in a nickel/dime poker game: it changes the nature of the game. The Proposed Rule correctly notes, "The CFMA, however, did not change the treatment of the enumerated agricultural commodities, which remained subject to Federal speculative position limits" (p. 4147). Yet the position limit exemptions CFTC regulators granted to swaps dealers, combined with the failure of exchanges to enforce even weak "position accountability," has enabled excessive speculation in both energy and agricultural commodities.

Unlimited trading in energy futures, when combined with the swaps dealer exemption for agricultural trades, affects not only indexed agricultural commodity prices, but also non-index agricultural contracts. Beginning to close what is colloquially known as the "Enron Loophole" by establishing energy trade position limits and reporting requirements, will be an important first step in restoring Congressionally mandated price discovery and price risk management functions to U.S. commodity futures markets, one pre-requisite for achieving energy and food security.

Comment on the Proposed Rule for Positions Limits on Referenced Energy Contracts

IATP commends the CFTC staff for drafting a clearly justified and articulated Proposed Rule. The CFTC's reassertion of its authority under the Commodity Exchange Act (CEA) to set position limits is well warranted, particularly in view of the failure of CFMA-authorized but

unenforced exchange set "position accountability" rules to prevent excessive speculation. By establishing position limits for each trader ("entity") across all classes of rule referenced contracts and aggregating those limits across all markets trading the referenced contracts, the Proposed Rule prevents any one trader or group of traders from, in effect, manipulating market prices, even unintentionally.

The most legitimate concern about the possibility that CFTC may set position limits too tightly is not "market migration risk." If investment banks, hedge funds and other swaps dealers, including those allowed by U.S. authorities to own deliverable commodities, wish to evade CFTC regulation by moving their trades to less regulated or unregulated markets, that is their perfect right, but trades driven by regulatory evasion carry risks too. These risks include managing traders' spot market price risks on the energy commodities they would sell in U.S. markets with energy futures contracts in foreign markets, unprotected by U.S. law and without the benefit U.S. exchange liquidity.

We believe that strengthening programs of regulatory cooperation between U.S., EU and other authorities will reduce the regulatory evasion motive for trade migration. We hope for further disincentives to regulatory evasion that result from pending U.S. legislation to limit U.S. commodity (and financial) market access for traders whose Foreign Boards of Trade (FBOT) have lower regulatory standards and enforcement performance than do post-reform U.S. markets. The Proposed Rule requests comment on U.S. legislation that would authorize the CFTC to regulate OTC derivatives and FBOT contracts traded by dealer brokers, insofar as that legislation may affect the Proposed Rule (p. 4163). IATP responds briefly to this request at the conclusion to our comment.

For the banks, hedge funds and non-bank swaps traders who choose to remain trading in U.S. markets, the Proposed Rule allows them to apply to the CFTC for a position limit exemption. The application would be limited to those rule referenced energy contracts in which the traders hold physical stocks, provided they qualify as bona fide hedgers seeking to manage price risk only for those hedged positions. The design of the Proposed Rule prevents those traders granted a bona fide hedge exemption for a contract exposure in their deliverable commodities from speculating beyond their hedging needs on those same contracts, as has recently occurred.[11] This tightly drawn exemption would protect the applicant's proprietary trading information from disclosure. However, the applicant would have to agree to publication of the fact that the CFTC had granted the applicant the exemption (p. 4160). Such publication would provide a much-needed and long overdue measure of transparency to enable all market participants to know who is benefiting from the exemptions. This transparency requirement may curtail unwarranted applications for position limit exemptions.

The concern that excessively tight position limits could restrict the liquidity needed to clear trades is a legitimate one. The Proposed Rule addresses this concern in two ways. First, by setting the position limit formulaically, as a percentage of all contracts ("open interest") in a given month, the position limit can be adjusted periodically as the trading volume and value of deliverable commodities in the referenced contracts warrant. If the position limit results in inadequate liquidity for the duration of the referenced contracts, the limits can be reset, following public consultation and a hearing of the CFTC's Energy and Environmental Markets Advisory Group. Second, by setting the position limit in terms of deliverable supplies of the

referenced contracts, and by prohibiting swaps dealers and other entities from speculating on contracts in which they have no bona fide hedging interest, the Proposed Rule provides for adequate liquidity relative to the aggregate position limits for deliverable commodities.

The speculation prohibition for exemption grantees prevents a flood of speculator liquidity that may not only induce price volatility but drive bona fide hedgers out of the market, one unfortunate result of the past decade of deregulation.[12] With regard to question 10 in the "Request for Comment," IATP believes that the position limit framework proposed for energy contracts should be applied to agricultural contracts, taking into account the CFMA ban on agricultural swaps.

Exclusion of application of the Proposed Rule to referenced contracts bundled in index funds

IATP regrets that the CFTC has proposed that "diversified commodity index futures that are based on such contracts' commodities would not be considered to be referenced energy contracts and, therefore, would not be subject to the proposed speculative position limits [...] because they [the indexed energy contracts] may not involve a separate and distinct exposure to the price of a referenced energy contract's commodity" (p. 4153). We are, however, pleased that the CFTC's request for comment includes questions on whether and how position limits might be applied to passively managed long index fund positions. IATP responds to only a few of these questions here, but all merit detailed response, in light of the price influence of index investors on all open contracts, both as prices increase following long bets and fall as investors leave the funds. For example, one analysis of 1092 technical trading models showed that index fund investments were major factors in increased energy and agricultural prices up to June 2008 and then helped to collapse them an aggregate of 60 percent by mid-November 2008, as index investors fled commodities.[13]

As of July 2008, index speculators accounted for 41 percent of open interest.[14] Index investing has declined since then, with major index fund dealers such as Goldman Sachs advising their clients to invest in commodities, but not through index funds.[15] We do not share the view that a tactical retreat from index funds, perhaps due to the trenchant analysis and bad publicity index funds have received over the past 18 months, should advise the CFTC to refrain from applying position limits to the contracts bundled in indices, such as the Standard Poors/Goldman Sachs Index. IATP is heartened that the CFTC began to publish a quarterly report of Index Investor Data in September 2009. Analysis of that data, if disaggregated for the rule-referenced energy contracts, as is the Disaggregated Commitment of Traders Report (DCoT) data, should enable the CFTC to determine the "separate and distinct exposure" of the referenced contracts within the index funds. We believe that comparative analysis of both data sets will show that the price effect of index investing on both indexed and non-indexed DCoT commodities remains larger than that indicated by the index investor share of open interest. Analysis of the data collected, together with position limits applied to index bundled contracts, may enable the CFTC to begin to regulate index funds effectively.

Regarding question 15 in the "Request for Comment," IATP believes that commodity market prices remain structurally vulnerable to the "weight of money" that index funds can bring to market, particularly in funds whose energy-dominant components are not subject to position limits. The United Nations Food and Agriculture Organization (FAO) Food Price Index of

internationally traded agricultural commodities reports price increases every month since August 2009 and believes that agricultural markets remain vulnerable to index fund investments.[16] Although agricultural futures prices are only one factor in price transmission and formation, the global economic dominance and regulatory influence of U.S. agricultural commodity markets is such that the CFTC should propose a position limit rule for index funds in order to comply with its public interest mandate (7 USC, Sec. 5, paragraph 1031 Commodity Exchange Act), as well as with the statutes concerning price discovery.

For many of the two-thirds of developing countries that are net food import–dependent, the inability to use risk-management tools effectively in markets of index fund–induced volatility has lead to crushingly high food and energy import bills.[17] Despite the 30 percent decrease in aggregate agricultural prices since the June 2008 peak, the FAO Food Index prices remain 70 percent above 2000 levels, with retail food prices still near their 2008 levels.[18] Although net financial transfers from developing countries to developed countries have decreased from a record high $891 billion in mid-2008 to $568 billion in mid-2009,[19] the loss of price risk management capacity exacerbates the precarious financial state of the food import–dependent countries that have suffered these net capital outflows. Food and energy insecurity are two principal factors in the political instability in at least 30 countries that Director Blair identified in aggregate as the number one U.S. national security threat. Applying position limits to the referenced contracts in index funds would be a means to reduce the import price volatility conducive to that instability.

Concerning the CFTC-posed question (15 b) on criteria for identifying and defining index traders and positions for the purpose of applying position limits to indexed contracts, IATP believes that there are two initial criteria for the CFTC to consider. The first criterion is whether the CFTC determines that the indexed contracts perform a significant price discovery function, according to the terms of Section 2(h) (7) of the CEA. This determination would have to take into consideration the extent to which the regulated component contracts of the index fund can be effectively arbitraged by all market participants among different trading venues and among the "look alike" contracts that are not traded on regulated exchanges and/or over the counter and thus are not currently subject to CFTC regulation. Such contracts would include mixed OTC swaps (e.g., oil contracts to offset interest rate volatility).

The second criterion for defining index funds is whether aggregate position limits applied to some component contracts, but not all, of an index fund, will inhibit excessive speculation. For example, a fund composed largely of position-limited enumerated agriculture and energy contracts will likely reduce the incentive for excessive speculation, but a fund composed of unlimited metal contracts, non-enumerated agricultural and energy contracts, and perhaps in the future, carbon dioxide emissions contracts, could elude rules to prevent excessive speculation. While energy contracts are currently preponderant in index funds, fund formulas could be recomposed towards a heavier weighting for commodities not subject to position limits; e.g., substituting agricultural "softs" (e.g., coffee, cocoa) for position-limited agricultural commodities or substituting unlimited carbon dioxide emissions contracts for position-limited energy contracts. In response to the CFTC's question (16 c) "Should diversified commodity indexes be defined with greater particularity?" IATP answers "yes" and would add "with a provision to define the index funds according to the fund formula composition of the contracts in the fund. The CFTC should define such funds so as to allow the bundling only of position-limited commodities."

IATP would like to make a final comment on index funds regarding an issue raised indirectly in the CFTC Request for Comment. Whether passive, long only index funds provide the quality and quantity of liquidity that enables price discovery and price risk management is a hotly contested topic among market participants. The CFTC has therefore requested comment on the question of whether to position-limit passive long traders (p. 4163, 15 a). IATP believes that there is sufficient evidence of damage to market integrity to warrant such position limits and that the limits can be applied under current CFTC authority. However, the CFTC may wish to hold a hearing on index funds to gather further evidence, commission a staff paper on index fund behavior and performance, and request the European Commission to likewise hold a hearing and commission a paper on index trading of contracts under its authority.

Whether the CFTC should set position limits for precious metals and soft agricultural commodity contracts

IATP is pleased that the CFTC is considering setting position limits for these contracts. As we remarked above, absent such position limits, index fund formulas could be recomposed to avoid aggregate position limits in precious metals and soft agricultural commodity contracts, as well as non-referenced energy and carbon emissions contracts. We have no competence in precious metals and so have no comment on position limits for those contracts.

Export revenues from agricultural softs such as cocoa, coffee and tea, are major sources of export revenue for many developing countries. However, the dismantling of commodity marketing boards required by international financial institutions in structural adjustment programs and their replacement by trading and processing oligopolies have left producing countries with little price risk management capacity, and declining market power and producer country share of world prices. For example, in the case of cocoa, the four leading African producing countries capture about five percent of the retail cost of chocolate in the United Kingdom.[20] As a result of weakening cocoa export revenues and consequent producer country inability to diversify, the UN Conference on Trade and Development (UNCTAD) will host an April 19–23 meeting in Geneva to negotiate a successor to the International Cocoa Agreement, 2001.[21]

The public interest protection mandate of the CEA arguably does not extend to agricultural soft producing countries, but only to the aforementioned oligopolies and other traders who participate in markets under CFTC authority. Nevertheless, agricultural softs are vulnerable to excessive speculation, whether or not they are bundled into index funds. The price volatility that is induced by liquidity far beyond what is required for physical hedgers exacerbates the supply-demand price volatility that the International Cocoa Agreement and similar agreements for agricultural softs seek to temper. By setting position limits for agricultural softs, the CFTC could both enable price discovery and price risk management for U.S. market participants and indirectly benefit those producer countries that are World Trade Organization–restricted from having marketing boards or state trading enterprises to carry out risk management functions.

Concluding Comment

IATP finds it difficult to respond to question 13, concerning how the CFTC should take into account the legislation pending in Congress on over-the-counter derivatives and Foreign Board of Trade contracts. If 60 percent of OTC and most FBOT contracts remain exempt from clearing,

as Chairman Gary Gensler remarked of the exemptions currently in the "Wall Street Reform and Consumer Protection Act of 2009,"[22] aggregate position limits will have a very limited capacity to prevent excessive speculation. If trades are not cleared on regulated exchanges or authorized derivatives clearing organizations, but remain in the dark market of bilateral swaps, it is unlikely that the CFTC will have enough trading data to set position limits with confidence. Such confidence is needed to ensure that those limits will be fair to derivatives end users who do contribute the timely price information to the market that OTC traders do not.

IATP, as a member of the Commodity Markets Oversight Coalition, has written to both Congress and the CFTC to advocate that the OTC trading standard must be whether or not trades can clear on exchanges or other regulated trading venues, not whether or not they are "customized."[23] (The degree of purported customization usually varies from standardized exchange contracts only in delivery place and/or date. In any event, the so-called customized contracts are usually copyrighted language that is applied to multiple contracts, and hence cannot be considered to be "customized" in any material way.) IATP is not persuaded by the Coalition of Derivatives End Users' (Coalition) argument that OTC swaps between banks and non-banks should be exempt from clearing on an exchange because the margin cost of exchange trading is too expensive.[24]

Most of the signatories to the Coalition letter are major corporations, such as Cargill and John Deere, or trade associations representing major corporations. Since exchange-traded margin requirements are generally no higher than eight percent of the contract cost, one wonders about whether such cash-strapped firms have sufficient capital reserves, when an eight percent (or lower) margin cost is purportedly enough to break the company bank. Although most OTC swaps concern interest rates, commodity users of such swaps will benefit by the cost efficiencies, as well as price information transparency, of clearing those swaps on regulated exchanges.[25]

In the Coalition language advocated on December 3 for what became the "Wall Street Reform and Consumer Protection Act of 2009," passed by the House of Representatives on December 11, business users of both commodity and financial derivatives would be exempt from having to post margin.[26] The rationale for this exemption is that business derivatives users do not pose systemic risk to the financial system. It is true that most end users individually do not trade OTC derivatives in sufficient volume as to pose systemic risk to the financial system, as do the Tier 1 (i.e., so-called "Too Big To Fail") banks that are usually the counterparties for OTC swaps. However, if business derivatives users in aggregate are exempted from clearing these bilateral trades with Tier 1 banks and other major swaps dealers on regulated exchanges, those exempted trades will enable transmission of Tier 1 and other major swap dealer risk to the entire financial system. The Coalition may just as well print a member t-shirt stating "I am okay with endangering the financial system, because I don't want to post margin."

Finally, in the "Wall Street Reform" bill, business end users are exempt from OTC trade clearing if they claim that OTC trades "hedge" balance sheet and operational risk and not just price risk on specific commodity and financial contracts. If this and the other loopholes in the "Wall Street Reform" bill are not closed in the Senate bill and House-Senate conference bill, physical hedgers will be at even greater competitive disadvantage than they are under the present exemptions for swaps dealers. If a major swaps participant, e.g., Cargill or British Petroleum, is able to "hedge"

balance sheet or operational risk and do so without position limit in dark markets, while their competitors in commodities futures and options trading are position limited, it will be impossible for the CFTC to ensure market integrity. Finally, it is worth remembering that hedging operational and balance sheet risk with OTC swaps to disguise debt in Special Purpose Vehicles is not a prudent exercise of fiduciary duty—just ask the Greek government if they would buy those Goldman currency swaps again, rather than tighten budget controls to meet the EU deficit mandate.

IATP thanks the CFTC for its consideration of these comments and looks forward to the opportunity to comment on future proposed regulatory measures.

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[1] Steve Suppan/IATP "Comments for the U.S. Commodity Futures Trading Commission Hearings on the Trading of Energy and Energy Derivatives," available at http://www.tradeobservatory.org/library.cfm?refID=106638.

[2] E.g., Frank Rich, "The Other Plot to Wreck America," *The New York Times*, January 10, 2010, and David Weidner, "Volcker and Reform Defeated," *The Wall Street Journal*, February 4, 2010.

[3] Jeremy Grant and Brooke Masters, "Brokers set out to fight backlash against OTC trade," *Financial Times*, April 28, 2009.

[4] http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20091020_563_en.pdf

[5] Adam K. White, "Academics and Analysts Acknowledging That Speculation Drove the 2008/2009 Oil Bubbles," September 26, 2009. Available at http://accidentalhuntbrothers.com/?p=661#respond.

[6] Michael W. Masters and Adam K. White, "The 2008 Commodities Bubble: Assessing the Damage to the United States and Its Citizens," February 4, 2009. Available at http://www.accidentalhuntbrothers.com.

[7] Christopher L. Gilbert, "Commodity Speculation and Commodity Investment," University of Trieste discussion paper, October 2008 at 14. Available at http://portale.unitn.it/bpmapp-upload/download/fstore/7f0000016c9f2f72_186c6b2_11e1bdac6d3_-7666/20_08_Gilbert.pdf.

[8] "Excessive Speculation in Wheat Markets," United States Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, June 24, 2009. Available at http://levin.senate.gov/newsroom/supporting/2009/PSI.WheatSpeculation.062409.pdf, *4–9.*

[9] Testimony of Michael Greenberger on behalf of Americans for Financial Reform before the Commodity Futures Trading Commission on Excessive Speculation: Position Limits and Exemptions, Commodity Futures Trading Commission, August 5, 2009, http://www.michaelgreenberger.com/files/CFTC_AFR_Sign_On_Testimony_August_3.pdf, 21.

[10] "A big move lies ahead," *The Brock Report*, May 23, 2008.

[11] David Cho, "A Few Speculators Dominate Vast Market for Oil Trading," *The Washington Post*, August 21, 2008.

[12] Michael W. Masters and Adam K. White, "How Institutional Investors Are Driving Up Food and Energy Prices," July 31, 2008, Graphs 1 & 2, http://accidentalhuntbrothers.com/wp-content/uploads/2008/09/accidental-hunt-brothers-080731.pdf, 33.

[13] Stephan Schulmeister, " Trading Practices and Price Dynamics in Commodity Markets and the Stabilising Effects of a Transaction Tax," Austrian Institute for Economic Research, January 2009, http://www.wifo.ac.at/wwa/servlet/wwa.upload.DownloadServlet/bdoc/S_2009_TRANSACTION_TAX_34919$.pdf, 4.

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[15] Sharman Mossavar-Rahmani et al., "Commodities: A Solution in Search of a Strategy," Investment Strategy Group, Goldman Sachs, January 2010, 11.

[16] "Food Outlook: Global Market Analysis," Food and Agricultural Organization, December 2009 at http://www.fao.org/docrep/012/ak341e/ak341e00.htm.

[17] "Developments and challenges in commodity markets: current situation and outlook," UN Conference on Trade and Development, January 10, 2010, http://www.unctad.org/en/docs/cimem2d7_en.pdf.

[18] The State of Food and Agriculture 2009,,Food and Agriculture Organization http://www.fao.org/docrep/012/i0680e/i0680e07.pdf, 106–107 and Figure 18.

[19] "World Economic Situation and Prospects 2010: Executive Summary," UN Department of Social and Economic Affairs et al., January 2010, http://www.un.org/esa/policy/wess/wesp2010files/wesp2010.pdf, 7–8

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[21] UN Cocoa Conference, 2010, UNCTAD, http://www.unctad.org/Templates/meeting.asp?intItemID=1942&lang=1&m=16465&info=doc.

[22] "Remarks of Chairman Gary Gensler, OTC Derivatives Reform, American Bar Association, Committee on Derivatives and Futures Law," Commodity Futures Trading Commission, January 29, 2010,,http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-26.pdf.

[23] See for example, http://www.nefiactioncenter.com/PDF/cmocltr2009oct08petersonfinal.pdf and http://www.nefiactioncenter.com/PDF/cmocltr2009aug05congressfinalcmbd.pdf.

[24] Letter to U.S. House of Representatives, Coalition of Derivatives End Users, October 2, 2009, available at http://www.tradeobservatory.org/library.cfm?refID=106911.

[25] Marcus Katz, "The New Environment and Financial Risk Management: Interest Rate Futures for the Corporate Treasurer," CME Group, 4—5.

[26] Comments to the Senate Banking Committee's Committee Print Title VII of the Restoring American Financial Stability Act of 2009, Coalition for Derivatives End-Users, December 3, 2009, available at http://www.tradeobservatory.org/library.cfm?refID=107145, 4.