RSC Republican Study Committee

Rep. Jeb Hensarling (R-TX), Chairman
Russ Vought, Executive Director
132 Cannon House Office Building
Washington, DC 20515

www.house.gov/hensarling/rsc
ph (202) 226-9717 / fax (202) 226-1633

Legislative Bulletin………………………………….…..………July 30, 2008

Contents:

H.R. 6604—Commodity Markets Transparency and Accountability Act (*Peterson, D-MN*)

Please note the possible conservative concerns on page 5.

Order of Business: The bill is scheduled to be considered on Wednesday, July 30th, under a motion to suspend the rules and pass the bill (therefore allowing no amendments to the bill, requiring a two-thirds vote for passage, and waiving all points of order).

What the House Did Last Month: On June 26, 2008, the House passed H.R. 6377 by a vote of 402-19. That bill would direct the Commodity Futures Trading Commission (CFTC) to utilize all its current authority, including its emergency powers, to:

- "curb immediately the role of excessive speculation in any contract market within the jurisdiction and control of the Commodity Futures Trading Commission, on or through which energy futures or swaps are traded; and
- "eliminate excessive speculation, price distortion, sudden or unreasonable fluctuations or unwarranted changes in prices, or other unlawful activity that is causing major market disturbances that prevent the market from accurately reflecting the forces of supply and demand for energy commodities."

Last month's bill did **not** alter the structure of the futures markets or the powers of the CFTC, thus a Member's vote on H.R. 6377 is not necessarily indicative of how a Member might vote on H.R. 6604.

Summary of H.R. 6604, as reported from committee: H.R. 6604 would significantly alter how the commodities futures markets operate. Key provisions of the legislation are as follows.

Energy Commodity. Defines "energy commodity" for purposes of the Commodity Exchange Act (and this legislation) to include coal, crude oil, gasoline, diesel fuel, jet fuel, heating oil, propane, electricity, natural gas, and “any other substance that is used as a source of energy,” as determined by the Commodity Futures Trading Commission (CFTC).

Foreign Boards of Trade. Requires U.S.-based commodity traders to comply with U.S. trading regulations, even when they are trading through foreign exchanges. Specifically, the bill would prohibit the CFTC, starting 180 days after this bill’s enactment, from allowing members of a foreign board of trade in the United States to participate in energy or agriculture futures trades unless the foreign board meets certain conditions, including:

- Making public trading information comparable to that required for domestically-registered entities;
- Adopting position limits (limits on futures investing) comparable to the domestically-registered entities;
- Possessing authority to mandate steps to prevent or reduce price manipulation, “excessive speculation” (as defined in the bill), price distortion, or the disruption of the delivery of cash settlement process;
- Agreeing to notify the CFTC “promptly” of any changes in the information just listed;
- Providing the CFTC with information regarding large trader information that is comparable to that required for domestically-registered entities; and
- Providing the CFTC with information regarding aggregate trader positions that is comparable to that required for domestically-registered entities.

Increased Data and Reporting. Requires a disaggregation of market data for energy and agriculture commodities and requires more detailed data on transactions be provided (and subsequently reported) separately by index traders (who have a more limited, more standardized portfolio of things they can trade) and swap dealers (who have a wider variety of things they can trade and who create made-to-order contracts).

The bill would also require traders to provide (and retain) more detailed information on their “over-the-counter” transactions (trades not going through an exchange or intermediary). Such trades are most often conducted by investment banks.

The CFTC would have to report on any energy or agriculture commodity trades equal to, or in excess of, any CFTC-set trading limits.

Trading Limits. Directs the CFTC, within 60 days of this bill’s enactment, to set limits for agricultural and energy commodities on the amount of positions (other than bona fide hedge positions) that may be held by any person with respect to futures contracts—for the spot month (month of delivery for a contract), each other month, and the aggregate for all months. Such limits would have to be designed to:

- “Diminish, eliminate, or prevent excessive speculation;
- “Deter and prevent market manipulation, squeezes, and corners;
- “Ensure sufficient market liquidity for bona fide hedgers;
- “Ensure that the price discovery function of the underlying market is not disrupted.”

“Bona fide hedging transaction” would have to be defined by the CFTC to include only those producers and purchasers of actual, physical commodities, and requires that such hedging be "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise."

Growth of the CFTC. Authorizes the addition to the CFTC of at least 100 new, full-time employees to "increase the public transparency of operations in agriculture and energy markets," and otherwise monitor price manipulation in commodities futures markets. The bill would also make statutory (under the Inspector General Act of 1978) an Inspector General for the CFTC. (The CFTC currently has a non-statutory inspector general.)

Study of Over-the-Counter Markets. Instructs the CFTC to study and report to Congress on the efficacy, practicality, and consequences of establishing limits on positions (other than bona fide hedge positions) for the agricultural and energy over-the-counter markets (direct trades not going through an exchange or intermediary, often done by investment banks).

GAO Studies. Directs the Government Accountability Office to study and report to Congress separately on:

- the international regulation of energy commodity markets; and
- the effects of "speculators" on agriculture and energy futures markets and agriculture and energy prices.

Over-the-Counter Market Assessments. Directs the CFTC to assess each over-the-counter commodity contract for its ability (alone or in conjunction with other such contracts) to cause a "severe market disturbance" or prevent the commodity's price from reflecting the forces of supply and demand. If necessary, the CFTC could then impose position limits and take corrective actions to enforce the limits.

Emergency Procedures. Allows the CFTC to use emergency and expedited procedures to carry out this legislation.

Additional Background: As the *Wall Street Journal* points out, futures markets are price-discovery mechanisms. Investors, traders, and, in the case of oil and gas futures, major energy consumers, like refiners and airlines, buy and sell these contracts to lock in goods at a future price, as a hedge against volatility. Futures contracts are guesses about coming oil supply and demand, as well as the rate of inflation. The more participants there are in a futures market, the better the price discovery is.

CFTC. Established by Congress in 1974, the U.S. Commodity Futures Trading Commission (CFTC) is an independent federal agency with the mission of regulating commodity futures and option markets in the United States. The goal was to replace the Commodity Exchange Authority with a more robust regulator. According to its website, "the CFTC assures the economic utility of the futures markets by encouraging their competitiveness and efficiency, protecting market participants against fraud, manipulation, and abusive trading practices, and by ensuring the financial integrity of the clearing process. Through effective oversight, the CFTC enables the futures markets to serve the important function of providing a means for price discovery and offsetting price risk." Learn more here.

7 U.S.C. 6a(a) gives the CFTC the authority to rein in "excessive speculation," as follows:

> Excessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets or derivatives transaction execution facilities causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity. For the purpose of diminishing, eliminating, or preventing such burden, the Commission shall, from time to time, after due notice and opportunity for hearing, by rule, regulation, or order, proclaim and fix such limits on the amounts of trading which may be done or positions which may be held by any person under contracts of sale of such commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility as the Commission finds are necessary to diminish, eliminate, or prevent such burden.

7 U.S.C. 12a(9) gives the CFTC the authority:

> …to direct the registered entity, whenever it has reason to believe that an emergency exists, to take such action as in the Commission's judgment is necessary to maintain or restore orderly trading in or liquidation of any futures contract, including, but not limited to, the setting of temporary emergency margin levels on any futures contract, and the fixing of limits that may apply to a market position acquired in good faith prior to the effective date of the Commission's action. The term "emergency" as used herein shall mean, in addition to threatened or actual market manipulations and corners, any act of the United States or a foreign government affecting a commodity or any other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity.

<u>Position Limits</u>. Futures contracts are already subject to certain position limits restricting the size of futures positions that traders are permitted to hold, subject to certain CFTC-granted exceptions.

Over the years, the CFTC has recognized that hedges of financial risk and the use of risk management strategies that diversify and reduce risk should be eligible for exemptions from these positions limits.

H.R. 6604 would prohibit the CFTC from making such exemptions in the future by defining hedging only as a transaction conducted by a commercial enterprise hedging a physical merchandising transaction. As a result, the futures positions that large pension plans and funds will be permitted to hold in energy and agricultural products, as part of a portfolio diversification or risk management strategy, would be notably constrained.

<u>Swaps</u>. A swap is where exchanged cash flows are dependent on the price of an underlying commodity, usually done to hedge against the price of a commodity. In one example of a swap, the user of a commodity would secure a maximum price and agree to pay a financial institution this fixed price. Then the user would get payments based on the market price for the commodity involved. On the other side, a producer wishes to fix his income and would agree to pay the market price to a financial institution, in return for receiving fixed payments for the commodity.

Swap dealers typically act as risk intermediaries. They assume risk from commercial and financial counterparties in the over-the-counter market and offset or manage their resulting exposures through transactions in futures contracts, over-the-counter transactions, or cash transactions.

H.R. 6604 would eliminate a swap dealer's current CFTC exemption from position limits, unless the dealer's swap counterparty is hedging in accordance with the new definition (physical delivery of goods only). As a result, the availability and cost of such swaps would likely increase, since the bill would effectively eliminate the availability of the futures market as a venue for swap dealers to hedge their over-the-counter swap risks.

RSC Bonus Fact: Southwest Airlines is one of the few American air carriers not losing money, mainly because of its extensive use of futures markets. As the *New York Times* reported recently, "Southwest's hedges, which cover 80 percent of the fuel that it buys, again proved its best protection against the problems faced by rivals."
http://www.nytimes.com/2008/07/25/business/25air.html?scp=2&sq=southwest&st=cse

Possible Conservative Concerns: Some conservatives might be concerned that this legislation is being used by Democrats to blame energy traders and investors for the recent spike in oil and gas prices, while distracting attention away from their consistent assault on American energy supplies. Some conservatives may also be concerned with an apparent misunderstanding of how futures markets work.

No Incentive to Push Prices Up. Traders and investors have no inherent incentive to push prices upward. In fact, as Alan Reynolds with the Cato Institute has asserted, there is nothing about futures or options that makes it any more attractive to bet that commodity prices will go up than to bet that they will go down. If an investor guesses wrong on the direction, he will lose money. If a company purchases the future right to buy oil at $120 a barrel and it instead sells for $100, the option becomes worthless. Plus, as the *Wall Street Journal* points out, "somebody has to take the other side of any futures contract: Some are trying to predict where the price will go in the future, while the other side is attempting to sell its future price risk. But no one knows how things will end up."

Futures Markets Not Based on Fantasy. Democrat rhetoric has implied that energy traders and investors push prices upward despite real-world forces that would otherwise keep prices lower. But commodities investments are not based on finger-in-the-wind guessing; they are based on detailed analyses of trends in the supply and demand of such commodities. If investors see trends pointing toward increasing world demand (such as the skyrocketing demand from India and China) and constrained supply relative to that rising demand (such as restrictions on drilling in ANWR or on the OCS, on the federal government procuring unconventional fuels from North America, and on expanding American refinery capacity), they are more likely to bet on the price going up. On the other hand, the futures markets would enable prices to fall faster than they would if we just had to wait for actual increases in supply. (For example, oil prices could drop immediately on the futures market from the mere *allowing* of drilling in ANWR, well before one drop of oil is extracted from there.)

Oil Prices Not Increasing Because of "Paper" Investors or Hoarders. Democrats have claimed that investors in oil futures have served to artificially increase prices because they don't actually take delivery of the oil and thus can afford to push prices higher on paper. But investors in oil futures often don't take delivery of oil because they sell their contracts before the contract expires to oil refiners and distributors, who *do* take delivery of oil. The investors are not hoarding the actual oil, evidenced, as Paul Krugman of the *New York Times* points out, by relatively stable oil and gas inventories in recent years, even as oil increased from $25 a barrel to $125 a barrel. This fact demonstrates that the rise in oil prices is clearly not the result of runaway speculation.

More Investors Are Betting on Prices Coming Down. Alan Reynolds with the Cato Institute notes that the "net long" position on the New York Mercantile Exchange fell from 113,307 contracts on March 11, 2008, to 25,246 by June 10, 2008—which means that far fewer traders are now betting that oil prices will rise further. JPMorgan analysts estimate that oil will drop to $85 a barrel from 2009 to 2011, citing cooling demand.

Ignoring the Truth. Democrats continue to blame traders and the oil companies themselves for the spike in oil and gas prices. But the American Petroleum Institute, as well as a variety of energy analysts, argue that prices rose because of soaring demand for oil for petrochemical products, electric power, and shipping from many emerging economies (especially China, India, and the Middle East). Simultaneously, the supply of oil slipped for a variety of reasons in the U.S., Mexico, Venezuela, Nigeria, and Russia. Plus, the falling value of the dollar has increased the price of imported goods. The result was a natural, expected spike in prices in the United States.

Could Harm Financial Markets and Energy Supply. H.R. 6604 could significantly harm the futures markets by reducing liquidity, reducing the number of players in the markets, weakening the price discovery mechanism of the markets, making it harder to hedge against risk, and possibly yielding higher commodity prices. And harming the markets means harming the nation's energy supply.

Mandates the Setting of Trading Limits. The current standard for the CFTC being allowed to set trading limits refers to transactions "causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, [placing] an undue and unnecessary burden on interstate commerce in such commodity." H.R. 6604 would jettison this flexible standard so that the CFTC would have to set trading limits within 60 days.

Makes Foreign Markets More Attractive. Investment naturally flows to markets with fewer restrictions. Thus, this substantial increase in regulation of the futures markets could drive capital to foreign markets without similar restrictions.

Growth of Government. The bill would authorize the hiring of at least 100 new federal employees for the CFTC for the purpose of expanding the federal reach into the sphere of private contracts. If the problem supposedly being addressed by this legislation is higher gas prices for Americans, why then would we want to place new financial burdens on Americans in the form of bigger government requiring more revenues from taxpayers?

Could Hurt Pensions. H.R. 6604 would significantly hinder the ability of major pension plans and investment funds to hedge inflation risks through exposures to broad-based commodity indices and to develop investment products that seek to protect retirement assets through diversification.

Allows Emergency Authority at Any Time. The bill would allow the CFTC to use emergency and expedited procedures to carry out this legislation at any time—not just during genuine emergencies. Such authority could send false signals to the markets about what is an emergency (a sudden fluctuation in a price and a threat to interstate commerce) and what is not (a political necessity to avoid voting on opening more lands to oil and gas development).

Jumping the Gun. On September 15, 2008, the CFTC is scheduled to issue a report on oil and gas futures and whether price manipulation exists. Plus, this legislation authorizes other studies into the markets, the impact of position limits, etc. Shouldn't Congress get the information from such reports first and THEN decide what action, if any, is necessary?

Outside Entities: The following entities have expressed public opposition to this legislation:

- American Bankers Association
- American Benefits Council
- American Council of Life Insurers
- Citigroup
- Committee on Investment of Employee Benefit Assets
- Credit Suisse
- ERISA Industry Committee
- Financial Services Forum
- Financial Services Roundtable
- Futures Industry Association
- Independent Petroleum Association of America
- International Swaps and Derivatives Association
- Investment Adviser Association
- Investment Company Institute
- JPMorgan Chase
- Managed Funds Association
- Merrill Lynch
- Morgan Stanley
- Profit Sharing/401(k) Council of America
- Securities Industry and Financial Markets Association
- U.S. Chamber of Commerce

Committee Action: On July 24, 2008, the bill was introduced and referred to the Agriculture Committee, which, on the same day, marked up and ordered the bill reported to the full House by voice vote.

Administration Position: The Statement of Administration Policy (SAP) indicates that the President's senior advisers would recommend that he veto the bill.

On July 29th, the President's Working Group on Financial Markets (consisting of the Secretary of the Treasury, the Chairman of the Securities and Exchange Commission, the Chairman of the Board of Governors of the Federal Reserve System, and the Chairman of the CFTC) wrote, in a letter to Rep. Randy Neugebauer (R-TX), that, "To date, the PWG has not found valid evidence to suggest that high crude oil prices over the long term are a direct result of speculation or systematic market manipulation by traders. Rather, prices seem to be reflecting tight global supplies and the growing world demand for oil, particularly in emerging economies. As a result, Congress should proceed cautiously before drastically changing the regulation of the energy markets."

Cost to Taxpayers: A CBO cost estimate was not available at press time. Presumably the authorized appropriations in this act would come from the additional CFTC employees, the additional CFTC authorities, and the various studies and reports required.

Does the Bill Expand the Size and Scope of the Federal Government?: Yes, the bill would expand the federal reach into the sphere of private contracts.

Does the Bill Contain Any New State-Government, Local-Government, or Private-Sector Mandates?: Although a CBO estimate including an analysis of the mandates in this bill is unavailable, presumably the restrictions on futures markets would be classified as private-sector mandates.

Does the Bill Comply with House Rules Regarding Earmarks/Limited Tax Benefits/Limited Tariff Benefits?: Though the bill contains no earmarks, and there's no accompanying committee report, the earmarks rule (House Rule XXI, Clause 9(a)) does not apply, by definition, to legislation considered under suspension of the rules.

Constitutional Authority: A committee report citing constitutional authority is unavailable.

RSC Staff Contact: Paul S. Teller, paul.teller@mail.house.gov, (202) 226-9718