Keynote Address by Commissioner Scott D. O'Malia, 2014 Bank of Canada International Economic Analysis Workshop on Financialization of Commodity Markets
Impact of the Dodd-Frank Act on Commodity Futures and Swaps Markets

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I want to thank Bahattin for inviting me to speak at this workshop. The topic of today's workshop is "Financialization of Commodity Markets." As we all know, commodity prices have experienced an unprecedented rise from the early 2000s. During this time, investors poured large amounts of investment capital into the commodity markets. As such, there has been much written about whether the increased presence of financial investors in the commodity markets led to higher commodity prices and volatility, the so-called "financialization of commodities" debate. Many of today's distinguished panelists have and will offer their insights on speculative activity in the commodity markets and its relationship to the financialization of these markets.

I would like to use this speech to frame the discussion of the impact of the Dodd-Frank Act and Commission regulations on commercial end-users who have historically used the commodity futures and swaps markets for risk mitigation and hedging. In this regard, I will first discuss the importance of hedging in the commodity markets, especially given volatile commodity prices. Next, I will discuss the impact that Dodd-Frank and Commission reforms have had on hedging in the commodity markets, including the "futurization" of swaps. I will then discuss the potential impact on hedging of upcoming Commission rulemakings. Finally, I will touch on the importance of the Commission's utilization of data in its oversight of the commodity markets.

Importance of Hedging in the Commodity Markets

It is important to remember that the futures markets originated as a way for buyers and sellers to hedge price risk in the grain markets.1 Today, notwithstanding investor participants in the commodity markets, participants from producers to manufacturers to commercial end-users continue to rely on the futures and swaps markets in order to hedge their commodity price risk, which is essential in order to operate, invest, and grow their businesses.

As we all know, commodity prices are not static. A good example of this price risk is natural gas. Even with the boom in natural gas production,2 this long and harsh winter reminds us that increased demand and supply disruptions can result in regional price spikes despite what seems to be an endless supply of natural gas. For example, the extreme cold temperatures this winter greatly increased demand and impacted production, storage, and transportation supplies for natural gas, causing cash prices in the Northeastern U.S. to hit record levels in late January.3 Chart 1 shows that ICE day-ahead cash prices for Northeast natural gas spiked to over $120 per million British thermal units at the end of January before falling back to more reasonable levels. The March – April natural gas spread has been similarly volatile this winter as shown in Chart 2. This spread widened to $1.208 on February 20 before narrowing. Given the increased demand and

supply issues for natural gas, storage levels of natural gas are the lowest in 11 years as shown in Chart 3. As of March 7, working gas in storage was 49 percent below last year's level and 46 percent below the five-year average.

Weather also brought the worst drought in decades to Brazil this winter, causing coffee crop losses of up to 30 percent.[4] May coffee futures peaked at $2.0975 a pound on March 12, the highest level since February 2012.[5] Weather is not the only factor that can cause volatility in commodity prices. The PED[6] virus, which has killed an estimated 5 million pigs in the U.S,[7] has sent lean hog futures prices to record highs.[8] Even the Crimean conflict contributed to increased wheat and corn prices this month.[9]

Given the volatility in commodity prices, hedging is an important function in the commodity markets so that participants can efficiently operate their businesses. Chart 4 provides an example of a potential consequence when a business does not hedge its exposure.[10] Unfortunately, in this example, Clean Currents closed its business because this past winter's "extreme weather … sent the wholesale electricity market into unchartered territories" and Clean Currents did not hedge this exposure.[11] In this regard, the Commission must be mindful of the impact of its rules on the cost of hedging for end-users so that they are able to engage in legitimate hedging activities. I will next discuss the impact of the Commission's swaps rules on hedging in the commodity markets.

Dodd-Frank Impact on the Commodity Markets

As you know, over the past several years the Commission has been busy implementing the Dodd-Frank Act. The Commission has completed 68 final rulemakings and 8 exemptive orders and the Commission staff has issued approximately 172 no-action relief letters and 34 guidance and advisories. The Commission now has 98 provisionally registered swap dealers, 19 temporarily registered swap execution facilities, and 4 provisionally registered swap data repositories. In a rush to complete the rulemaking process, the Commission preferred speed over precision. As a result, the Commission's swaps rules have introduced unnecessary complexity, vagueness, and costs into the markets, including the commodity markets. These consequences have, in certain instances, led some hedgers to seek out alternatives, such as swap futures. This trend is commonly referred to as the "futurization of swaps."

On October 12, 2012, the joint CFTC-SEC rule defining the term "swap" became effective,[12] which triggered compliance requirements for a number of Commission swaps regulations. To avoid compliance with burdensome and costly swaps regulations, customers of both CME and ICE demanded that the commodity markets move to listed futures instead of swaps. In response, on October 15, 2012, ICE converted its cleared energy swaps into futures and CME began listing energy futures contracts.

Following this shift, CME Group and Eris Exchange launched interest rate swap futures in December 2012.[13] Singapore Exchange began offering commodity futures for trading in April 2013.[14] ICE launched credit index futures in June 2013.[15] Earlier this year, Greenwich Associates noted that "a clear trend exists towards growing demand for FX

futures in lieu of traditionally bilateral FX derivatives."16 Market participants have cited the complexity and cost of complying with the new swaps rules as major drivers to the futures markets.17 Unlike the swaps markets, the futures markets have clear rules and provide market participants with regulatory certainty.

The Commission's unjustifiably complicated swap dealer definition18 and unjustifiably expensive compliance requirements for market participants that meet this definition is one example of a Commission rule that has pushed market participants to the futures markets. In addition to brokers, many other market participants, including energy, agricultural, and commodity firms have to worry about being subject to this definition. Rather than providing a bright line test for determining whether a market participant is a swap dealer, the rule broadly applies the swap dealer definition to all market participants and then provides some limited conditional relief, but only if participants navigate through the complex set of hedging factors on a trade-by-trade basis and fall below the $8 billion de minimis level.

In a few years, the $8 billion de minimis level will fall to $3 billion if the Commission does not vote to change the threshold. Earlier this month, I asked the Commission staff how many additional entities would have to register as a swap dealer if the de minimis level moved to $3 billion today. The Commission staff could not answer this question. If the Commission cannot determine if an entity falls within the swap dealer definition, how can it expect end-users to navigate this complex rule?

Think about this in another way. If the Commission cannot identify swap dealers, how can it enforce this rule? The Commission's data rules do not require a market participant to flag a trade as a dealing trade or a hedging trade. So, how will the Commission conduct compliance and oversight of this rule regardless of the de minimis level? I suspect that the Commission will add all trades executed by a market participant and see how close the total is to the de minimis level, and then ask questions to determine whether the economic purpose of each trade was dealing or hedging. This solution will be a nightmare for both the Commission and the end-users.

To provide end-users greater certainty, I propose a modest fix that would allow end-users to exclude all cleared trades from the calculation towards the de minimis threshold. This fix would encourage end-users to clear their trades and would reduce regulatory compliance costs for those end-users who choose to do so.

Moreover, as I noted before, once an entity is subject to the swap dealer definition, the cost of complying with the swap dealer regulations is high. Swap dealers must comply with an array of complex and costly rules in areas such as minimum capital requirements, business conduct, and trade reporting – giving participants a strong incentive to stay away from being labeled as a swap dealer. Participants in the futures markets do not have to comply with such onerous rules.

The downside of futurization for participants in the commodity markets is reduced hedging flexibility because futures contracts, unlike swaps, cannot be individually

tailored to meet specific risk needs. Given the volatility of prices in the commodity markets, and the different needs, risks, time horizons, and incentives for end-users in these markets, customized hedging is especially important.[19] Because of the Commission's rules, these participants will have to accept imperfect hedges, endure the higher cost of swaps, or forego hedging all together. All of these alternatives are unacceptable.

For example, smaller natural gas producers rely on customized hedging solutions to mitigate their exposure to volatile natural gas prices, which enables them to invest in their drilling programs.[20] There are more than 120 natural gas delivery locations in the U.S., which can vary significantly from the Henry Hub benchmark price traded on exchanges.[21] In addition, producers may need the flexibility to enter into long-dated hedges; however, approximately 80% of Henry Hub futures volume is traded within a two-year maturation date.[22] The lack of delivery locations and liquidity in long-dated hedges in the futures markets requires customized hedging solutions in many cases.[23] If end-users are forced to use swap futures because the cost of using swaps is too high, these participants will have a less perfect hedge, which could result in additional risk or reduced capital investment.[24]

Upcoming Changes to the Commodity Markets

There are several upcoming Commission rulemakings that will impact hedging in the commodity markets. First, the Commission is considering a proposed futures block rule that will limit the availability of block trades, especially for energy futures. Exchanges have facilitated the transition from swaps to futures in the commodity markets by establishing extremely low threshold sizes for block trades in futures contracts. These thresholds are unlikely to stay at these levels with a Commission futures block rule. It remains to be seen how Commission rules would affect futurization in the commodity and other markets and the cost of hedging to end-users.

Second, the OTC margin and capital rules for uncleared swaps will increase the cost of hedging. It is important to note that the effort to establish a margin regime for uncleared swaps is a global effort. In September 2013, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions released their final policy framework on margin requirements for uncleared derivatives.[25] These rules will spare end-users from mandatory initial and variation margin exchange. However, banks will be hit with new capital charges to offset the risk posed by OTC trades. Banks will pass these costs on to end-users. The Commission will need to finalize these rules, which will increase the cost of hedging for end-users in the commodity markets.

Third, the Commission staff is working on mandatory clearing determinations for additional interest rate swap contracts and non-deliverable forward ("NDF") contracts. As I previously mentioned, it appears that there is already growing demand for FX futures in lieu of traditionally bilateral FX derivatives. Only time will tell if mandatory clearing and trading accelerate the move of NDFs to futures. While mandatory clearing for commodity swaps is likely a year or more away, commodity market participants

should keep a close eye on clearing and trading in the interest rate, credit default, and NDF markets to determine how commodity markets may react in the future with the advent of mandatory clearing and trading. Commodity market participants should also watch for any impacts on the cost of hedging.

Finally, the position limits re-proposal has the potential to negatively impact end-users legitimate hedging activities. Setting position limits is not an easy task, especially with unusable data as I will discuss next. The Commission is supposed to stop excessive speculation and manipulation, but must also protect the essential price discovery process and hedging function in the markets. Unfortunately, the Commission's position limits re-proposal may curtail end-users hedging activities as it scales back the bona fide hedging exemption. The current bona fide hedging exemption has been in effect since the 1970s and, from my understanding, has worked well in the markets. In developing a final position limits rule, the Commission must ensure that it does not impact longstanding and legitimate hedging activities.

Commission's View into the Commodity Markets

I would like to next discuss the importance of the Commission's utilization of data in its oversight of the commodity markets. Two fundamental goals of the Dodd-Frank Act were to increase the transparency and integrity of the swaps markets. To achieve these goals, Dodd-Frank required market participants to report information about each swap transaction to a swap data repository.[26] The Commission promulgated swap data reporting rules and swap dealers began reporting their trades in December 2012.[27]

As important as data is, the Commission does not have a clear picture into the commodity swaps markets or financial markets, for that matter. Let me be clear. The data is extraordinarily difficult to use and the Commission is not utilizing this data effectively, or as it was intended. Without usable data, the Commission cannot conduct surveillance, set appropriate position limits, or analyze systemic risk in these markets. The swaps data is not merged with futures data and cannot be analyzed together. Despite the fact that market participants trade across markets and across jurisdictions with little effort; the Commission continues to struggle to develop its own oversight capacity, unless the Commission makes this a top priority.

However, I am pleased that the Commission is taking steps to improve the quality and consistency of its data. The Commission's Technology Advisory Committee, which I chair, started to perform work on data harmonization back in 2011. Based on this effort, the Commission is currently working with the swap data repositories to harmonize the data within the credit asset class and will then move on to the interest rate asset class. Commodities, unfortunately, are well down the road.

In addition, based on my suggestion, the Commission formed a cross-divisional data team in January of this year to identify and fix our data problems. The Commission, based on the data team's work, this past Wednesday put out for comment approximately 70 questions addressing several swap data reporting issues. Based on the comments and its

own self-evaluation of the current reporting regime, the cross-divisional data team will make recommendations to improve swap data reporting to the Commission this summer.

I cannot emphasize enough how important it is for the Commission to improve its data quality and utilization so that the Commission has an accurate and complete picture of the swaps markets. Without this view, the Commission cannot surveil the markets for manipulation and other abusive trading practices. In addition, the Commission will not be able to set credible position limits or determine whether end-users are hedging or speculating. The Commission's ability to perform vital risk analysis will also be compromised.

Conclusion

It is probably appropriate that I conclude my remarks by emphasizing that it is crucially important for the Commission to improve and effectively utilize its data so that the Commission develops a complete picture of both the swaps and the futures markets. In many respects, many of the questions regarding the impact of financialization on the commodity markets would be answerable if the Commission had a complete picture of market participants and their trading strategies.

In addition, the Commission must be mindful of the impact that its regulations have on the cost of hedging in the markets. This is especially true in the commodity markets where a wide range of participants hedge because of the volatility in commodity prices and specialized business needs. If the cost of hedging becomes too expensive, these participants may choose not to hedge or enter into less perfect hedges, which impairs efficient business operations.

Therefore, looking forward, the Commission must strive to issue clear, consistent, and cost effective rules that are informed by data and that do not interfere with hedging in the markets. Finally, the Commission must re-visit rules that have proved unworkable or overly burdensome. I am encouraged that the Commission has taken the first step by re-visiting its data rules. I encourage the Commission to not stop there and continue to re-visit rules that have impacted legitimate hedging activities.