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United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510–6250

November 1, 2010

SENT VIA EMAIL (CommodityETFs@cftc.gov)

Mr. David A. Stawick
Secretary, Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

RE: **Commodity Based Exchange Traded Funds**

Dear Mr. Stawick:

The purpose of this letter is to express concern about a concept release and proposal by the Commodity Futures Trading Commission (CFTC) to issue an order exempting from its regulatory and supervisory oversight the issuance and sale of options and futures for certain commodity-based Exchange Traded Funds linked to metals. As part of this proposal, the CFTC proposes to delay determining whether commodity-based Exchange Traded Funds (ETFs) qualify as securities or commodities. Given the prominence of commodity-based ETFs and their potential impact on commodity prices, supplies, and markets, I respectfully suggest that a better course of action may be for the CFTC to make a determination that commodity-based ETFs are hybrid financial instruments that combine features from both securities and commodities transactions, and should be subject to joint regulation by the CFTC and Securities and Exchange Commission (SEC) in the same manner as "mixed swaps" under Section 712(a)(8) of the Dodd-Frank Act. This determination regarding the status of commodity-based ETFs would not preclude a simultaneous decision to authorize the issuance and sale of options and futures related to such ETFs.

Exchange Traded Funds. Exchange Traded Funds enable investors to buy and sell shares in the fund on a stock exchange in the same way that investors can use the stock exchange to buy and sell shares in a corporation. ETFs linked to commodities appeared on U.S. stock exchanges for the first time about six years ago, when an ETF linked to gold was offered for sale in 2004. Today, retail investors and other market participants can use stock exchanges to buy and sell shares in a wide variety of commodity-based ETFs, some of which track broad commodity indexes, others of which track sub-indexes, and some of which reference a single commodity. By buying and selling these shares, commodity-based ETF traders gain exposure to commodity prices without ever having to transact business on a commodity exchange subject to CFTC oversight.

The particular type of ETF addressed in the CFTC's proposal is structured as a trust whose assets are limited to a single physical commodity, either palladium or platinum. The ETF's investment objective is to track the spot price of the specified commodity, less trust expenses, and provide its shareholders with exposure to the changes in the commodity price. This type of ETF typically does not sell or redeem individual shares, but instead sells large blocks or "baskets," in units of 25,000 to 200,000 shares each, to broker-dealers or other financial institutions known as Authorized Participants (AP). In return, as a condition of the sale, APs are required to deliver to the ETF a specified amount of the physical commodity to support the value of the ETF shares being issued.[1]

APs then sell the individual ETF shares to investors through the stock exchange. If the commodity price increases, the share values increase, and the investors gain; if prices drop, the share values fall, and investors lose. If the fund attracts more investors, the ETF typically sells more blocks of shares and receives additional commodity deliveries to support those shares; if investments in the fund decrease, the ETF typically reduces its commodity holdings. The commodities underlying these ETFs may be purchased in commodity markets overseen by the CFTC or in markets outside of the United States and CFTC control.

Subcommittee Investigation. For more than five years, the Permanent Subcommittee on Investigations, which I chair, has examined issues related to U.S. commodity markets, including pricing issues involving the crude oil, natural gas, and wheat markets. In its most recent investigation, the Subcommittee released a bipartisan 260-page staff report and held a July 21, 2009 hearing examining commodity index trading in the wheat market. One key topic was the impact of commodity index-based ETFs on futures contracts and commodity prices.

During the course of its year-long investigation, the Subcommittee compiled and analyzed millions of trading records from U.S. wheat futures markets in Chicago, Minneapolis, and Kansas City, as well as pricing data from various wheat cash markets. We researched a variety of data, trading, and policy issues and interviewed numerous experts. Our report concluded that the huge number of wheat futures contracts being purchased by derivative dealers to support commodity index financial instruments had, in the aggregate, constituted excessive speculation in the Chicago wheat market, resulting in unwarranted price changes. A portion of the futures contracts reviewed were purchased by derivative dealers selling commodity index-based ETFs linked to agriculture commodities, including wheat. Essentially, the report found that the purchase of wheat futures contracts to support the commodity index financial instruments, including ETFs, swaps, and exchange traded notes, had created a new demand for those futures contracts; had distorted the prices of those futures contracts by overwhelming normal supply and demand factors; had interfered with the convergence of wheat futures and cash prices; and had hurt American businesses and consumers by causing unreliable wheat prices and hedging failures.

ETF-Generated Demand and Supply. While the ETFs under consideration in the proposed concept release do not reference commodity indexes, the Subcommittee's work indicates they could have a similar impact on commodity prices, supplies, and markets. The

[1] The proposed rule states that the proposed exemption order will not be applied to ETF Commodity Pools that track a benchmark index or commodity by engaging in the purchase of commodity futures or option contracts.

ETFs under consideration are expected to routinely acquire from their APs a physical inventory of metal commodities to support the value of their shares. These ETFs would acquire a larger inventory when the fund is growing, and sell portions of that inventory if the fund loses investors. In the aggregate, pro-cyclical purchases and sales of physical commodities to support commodity-based ETFs could exaggerate swings in commercial inventories and price volatility. In addition, additions to or subtractions from ETF inventories may have little or no relation to supply and demand fundamentals applicable to commercial users of the commodity; ETFs will be responding instead to investors speculating on commodity price changes. Yet ETF acquisition and disposition decisions may, in the aggregate, affect spot and futures prices as well as the commodity supplies available for commercial use.

The impact of ETF-generated trades may be especially significant in the context of the two metals under consideration. Palladium and platinum are rare metals used to produce many modern manufactured goods, including computers, mobile telephones, catalytic converters in automobiles, and fuel cells. Platinum is also used in jewelry. As highlighted in the proposed concept release, palladium and platinum are mined in primarily two countries, South Africa and Russia, which together produce a relatively small volume of the metals each year. This limited production, combined with ongoing demand for the metals, makes both commodities relatively more susceptible to supply disruptions, price volatility, squeezes, and corners.[2] One manufacturer told the Subcommittee that ETFs have generally "led to greater volatility and in some cases higher prices in metals markets (due to increased speculation and the fact that metals inventory gets 'trapped' in warehouses supporting the ETFs)." The facts indicate that an ETF acquiring or disposing of its palladium or platinum stocks could inadvertently or even deliberately disrupt the market for the metals or affect their prices, and raise regulatory concerns related to excessive speculation and price manipulation.[3] Those market dangers are particularly acute for single-commodity ETFs, which tend to have smaller markets and greater price volatility than ETFs based upon a broad basket of commodities.

Closing The Regulatory Gap. Despite their widespread availability on U.S. stock exchanges and the billions of dollars invested in them, commodity-based ETFs are not regulated to the same extent as other investment vehicles. They are not subject to registration under the Investment Company Act of 1940, are exempt from SEC regulations applicable to investment companies, and do not receive the same scrutiny as mutual funds. ETF shareholders, who hold interests in a trust, do not have the same rights or regulatory safeguards as shareholders in a publicly traded corporation. Commodity-based ETFs also do not quality as commodity pools, are not subject to regulations applicable to commodity pool operators or commodity futures, and operate outside the CFTC's large trader reporting system. To date, the CFTC has not even determined whether commodity-based ETFs qualify as securities or commodities. Due to these reporting and regulatory gaps, the CFTC is currently flying blind in its monitoring, analysis, and understanding of how commodity-based ETF trades, individually and in the aggregate, affect commodity prices, supplies, and markets. The recent financial crisis has already demonstrated the dangers associated with such gaps in oversight.

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[2] See, e.g., Prospectus for ETFS Platinum Trust (May 28, 2010) at 6 (identifying a "short squeeze" as a key risk factor for investors).

[3] See id. at 7 (acknowledging that purchases and sales of platinum in connection with the ETF could affect the metal's market prices and global supplies).

Commodity-based ETFs are designed to function as hybrids. They are made available for purchase by retail and institutional investors on U.S. securities markets, but provide investments in commodities.[4] Commodity-based ETFs, which continue to evolve in variety and complexity, have direct impacts on commodity supplies and spot and futures prices in both the regulated and over-the-counter commodity markets. Authorizing futures and options on these commodity-based ETFs would further blur their regulatory status as securities versus commodities transactions, and invite traders to engage in arbitrage over one class of transactions that is subject to CFTC oversight versus another that is economically similar, but immune to CFTC regulation. Another consideration is that allowing options on ETFs may increase price volatility for the underlying commodities and thereby increase hedging costs for commercial users -- concerns that call for CFTC oversight. In addition, exempting options and futures on commodity-based ETFs from CFTC oversight would allow ETF managers, Authorized Participants, and ETF traders to take positions in financial instruments that are functionally equivalent to CFTC-regulated products, but which would escape CFTC surveillance, large trader reporting, and market policing.

Failing to exercise CFTC jurisdiction over single-commodity ETFs linked to palladium and platinum commodities would be particularly ill-advised, given the relatively small size of the markets for both metals and the possible impact of ETF trades on those markets. The CFTC should assert its authority to conduct surveillance, require large trader reporting, and take enforcement actions to detect, prevent, and punish any price manipulation or excessive speculation by ETFs linked to palladium or platinum. In addition, the CFTC should make it clear that ETF managers, Authorized Participants, and ETF traders are subject to the same position limits applicable to other market speculators in these metals.

Hybrid Financial Product. The CFTC has yet to determine whether commodity-based ETFs qualify as securities or commodities, and has requested comment on whether it is time to resolve that issue or allow it to continue unanswered. Given the growing importance of commodity-based ETFs as an investment vehicle and their potential impact on commodity markets, it is past time to clarify their status.

The reality is that commodity-based ETFs incorporate features from both securities and commodities. Rather than assign them to one or the other category, or relinquish CFTC jurisdiction over financial products with a direct and potentially significant impact on commodity prices, supplies, and markets, perhaps the best regulatory approach would be for the CFTC and SEC to categorize commodity-based ETFs as a hybrid financial instrument -- a "mixed security" subject to joint CFTC-SEC oversight in the same manner as "mixed swaps" under Section 712(a)(8) of the Dodd-Frank Act. This designation would allow both agencies jointly to design disclosure, regulatory, and oversight procedures appropriate for these financial products.

Determining that commodity-based ETFs are a hybrid financial instrument subject to joint CFTC-SEC oversight would not preclude the CFTC's authorizing the issuance and sale of options and futures with respect to those ETFs, which is the issue presented in the pending proposal. The CFTC could authorize options and futures for palladium and platinum ETFs

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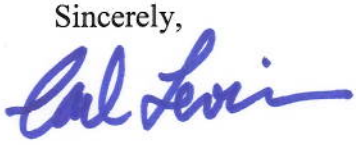
[4] See id. at 20 ("The Shares are intended to offer investors an opportunity to participate in the platinum market through an investment in securities.")

specifically, or for metals-based ETFs generally, while also issuing a determination regarding the mixed nature of commodity-based ETFs as a whole. The CFTF could then initiate a joint process with the SEC to design appropriate commodity-based ETF disclosures; authorize the imposition of CFTC position limits; and establish procedures enabling the CFTC and SEC to detect, prevent, and punish any price manipulation, excessive speculation, or other market abuses carried out through ETF products.

Thank you for this opportunity to comment on the proposed rule.

Sincerely,



Carl Levin
Chairman
Permanent Subcommittee on Investigations