Testimony of Michael Greenberger
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on behalf of

Americans for Financial Reform

before the

Commodity Futures Trading Commission

on

Excessive Speculation: Position Limits and Exemptions

August 5, 2009

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I want to thank Chairman Gensler for extending an invitation to me to testify at this important set of hearings. I am also pleased to have been asked by the Steering Committee of Americans for Financial Reform to testify on behalf of that nearly 200 member coalition today. The Steering Committee of the Americans for Financial Reform is attached. The Maryknoll Office for Global Concerns, the Institute for Agriculture and Trade Policy, Grassroots International, Food & Water Watch, and the New Rules for Global Finance Coalition also support this testimony.

Americans for Financial Reform. Americans for Financial Reform ("AFR") is a coalition of nearly 200 national, state and local consumer, employee, investor, community and civil rights organizations who seek meaningful reform of our banking system and financial markets. A list of the AFR coalition partners who have joined AFR's "call to action" for financial regulatory reform can be found at http://ourfinancialsecurity.org/about/our-coalition/.

At the beginning of these hearings, Chairman Gensler quite eloquently reflected this Commission's statutory mandate to ensure for the sake of the American public at large that the nation's futures markets perform in a fair and orderly fashion:

> "The work we do and the policies we implement have meaningful implications on the day-to-day lives of the American people. Futures markets not only provide critical risk management for farmers, producers and other market participants, but they also affect the decisions families make around the dinner table.
> Gasoline prices, for example, can determine whether a family takes a summer vacation. Natural gas futures contracts affect utility bills, and lack of convergence in the wheat market can shorten a grocery list.
> It is our job to make certain that futures markets work for the American people."

We could not agree more. Americans who do not directly participate in (and may not be aware of) derivatives markets are nevertheless, as the Chairman has said, directly impacted in their "day-to-day lives" by the activities in these markets.

Unregulated Derivatives Markets and the Financial Meltdown. We now know that the unregulated multi-trillion dollar OTC credit default swaps derivatives market, for example, fomented a mortgage crisis, then a credit crisis, and finally a "once-in-a-century"[1] financial crisis that, but for trillions of dollars of U.S. taxpayer interventions, would have completely destroyed our financial system. As it is, we are, nevertheless, in the middle of a financial storm in which average Americans are still experiencing mounting job losses, foreclosures, bankruptcies and governmental budget deficits at a record and destabilizing pace.

[1] Testimony of Alan Greenspan, House Committee of Government Oversight and Reform, Oct. 23, 2008.

It is for that reason on July 30, 2009, AFR sent to the Congressional leadership a letter expressing its support for those Obama Administration and Congressional proposals that would return risk shifting commercial derivatives markets to where they were prior to passage of the highly deregulatory Commodity Futures Modernization Act of 2000, by requiring virtually all derivatives to be traded on fully transparent and well capitalized exchanges with rare exceptions granted for specifically tailored and individually negotiated commercial risk shifting needs that are approved by a federal regulator as being, *inter alia*, adequately capitalized and consistent with sound and orderly financial practices.[2]

AFR also supported in that letter the Obama Administration proposal that those who make a market in all derivative products (wherever traded and however regulated) be overseen by a federal regulator that assures those institutions comply with conservative capital, record keeping and business conduct rules.[3]

We would also refer the Commission to the July 2009 Report by a Blue Ribbon "Independent Task Force" composed of distinguished experts, *i.e*., the Investors' Working Group co-chaired by former SEC Chairmen Arthur Levitt, Jr. and William H. Donaldson, which reaches many of the same conclusions advanced by AFR in its July 30 letter.[4]

Exchange Trading of All Derivatives Will Ease The Oversight of Excessive Speculation. As has already been discussed at these hearings and as will be addressed below, the CFTC, because of the CFMA, does not now have oversight over the trading of physical over-the-counter derivative products that are exempt or excluded from its jurisdiction. Therefore, many of the remedies discussed at these hearings, *e.g*., applying speculative position limits to control excessive and destabilizing speculation in energy and food markets, will at best have limited reach to only those portions of the derivatives markets that the CFTC now oversees. To the extent that CFTC supervised exchange trading becomes required, which AFR supports, the ability of the CFTC (or perhaps the SEC to the extent that agency shares in the supervision of newly regulated derivatives markets as has been widely discussed) can guard against volatile and unnecessary price spikes in energy and food on a uniform, rather than partial, basis.

Recent Energy Price Spikes Defy Market Fundamentals. AFR fully understands that economic instability experienced by Americans is not due only to unregulated *financial* derivatives, such as credit default swaps. The personal finances of most Americans have, in

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[2] Letter from Americans for Financial Reform to the United States Senate and United States House of Representatives (July 30, 2009), *available at* http://ourfinancialsecurity.org/2009/08/afr-urges-congress-to-regulate-the-derivatives-markets/ (last visited Aug. 3, 2009).
[3] *Id.*
[4] Investor's Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective (July 2009), *available at* http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf (last visited Aug. 2, 2009). The Task Force was commissioned by the CFA Institutional Centre for Financial Market Integrity and the Council of Institutional Investors.

recent months, taken a serious beating because of destabilizing price spikes in traditional physical commodities, such as oil, gasoline, heating oil, and basic food staples. As one prime example, we have seen dizzying volatility in crude oil prices during the last 18 months: with no underlying change in supply and demand, the price of crude oscillated from $65 per barrel in June 2007 to $147 in July 2008 to $30 in December 2008 and back up to $72 in June 2009.[5]

On September 22, 2008 alone, the price of a barrel of crude oil posted a single day record rise of $18.56 and then dramatically dropped $14.75 the very next day, eventually dropping to near $30 a barrel by December 2008.[6] The September 22 single day crude oil price *increase* of over $18 must be put into the saddening context that as recently as January 2002 the *entire* price of a barrel of crude was only $18.[7]

As Michael Masters in June 4, 2009 Senate hearings observed, while oil prices fluctuated wildly, "U.S economic output was dropping during the first six months of 2008. During that time, worldwide supply of oil was increasing and worldwide demand for oil was decreasing. . . . According to the Energy Information Agency (EIA), the available supply of crude oil in the United States is at a 20-year high, while the demand for crude oil is at a 10-year low. The International Energy Agency (IEA) sees a similarly bleak supply and demand outlook for the world as a whole. *And, yet, despite this glut of unwanted oil, the price has risen an amazing 85% per barrel from the mid-$30s to mid-$60s. In fact, oil prices increased more in the month of May [2009] than in any other month for the last 10 years*."[8]

While crude oil surged over $70 per barrel in early July, Goldman Sachs, one of the leading marketers of passive investments in commodity swaps indexes heavily concentrated on

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[5] Organization of Petroleum Exporting Countries, World Oil Outlook 2009, *available at* http://www.opec.org/opecna/Speeches/2009/attachments/WOO09presentation.pdf (last visited Aug. 2, 2009); Gordon Brown and Nicolas Sarkozy, *Oil Prices Need Government Supervision: Producers and consumers benefit from stability*, WALL ST. J., July 8, 2009, *available at* http://online.wsj.com/article/SB124701217125708963.html (last visited Aug. 2, 2009); INTERNATIONAL MONETARY FUND, *REGIONAL ECONOMIC OUTLOOK: MIDDLE EAST AND CENTRAL Asia*, 27-28, May 2008, *available at* http://www.imf.org/external/pubs/ft/reo/2008/MCD/eng/mreo0508.pdf (last visited Aug. 2, 2009); Price data for Cushing, OK WTI Spot Price FOB (Dollars per Barrel), ENERGY INFORMATION ADMINISTRATION, *available at* http://tonto.eia.doe.gov/dnav/pet/hist/rwtcd.htm (last visited Aug. 2, 2009).

[6] Data for Cushing, OK WTI Spot Price FOB (Dollars per Barrel), published by The Energy Information Administration, *available at* http://tonto.eia.doe.gov/dnav/pet/hist/rwtcd.htm (last visited Aug. 2, 2009).

[7] Jad Mouawad & Heather Timmon, *Trading Frenzy Adds to Jump in Price of Oil*, N.Y. TIMES, Apr. 29, 2006, *available at* http://www.nytimes.com/2006/04/29/business/29traders.html (last visited Aug. 2, 2009).

[8] Testimony of Michael Masters, U.S. Senate Comm. on Agriculture, Nutrition, and Forestry at 3-4, June 4, 2009 (emphasis added and interior citations omitted), *available at* http://216.40.253.202/~usscanf/index.php?option=com_events&task=view_detail&agid=32&year=2009&month=06&day=04&Itemid=44 (last visited Aug. 2, 2009).

crude oil, raised its estimates for oil prices, predicting $85 per barrel of oil by the end of the year, and $100 per barrel of oil by 2011.[9]

Needless to say, volatility in crude oil markets has led to corresponding volatility in crude oil's derivative products, such as gasoline and heating oil. Last summer, gasoline prices rose to over $4 a gallon[10] and heating oil jumped from 315 cents per gallon in April to over 400 cents per gallon in July.[11]

As Senator Sanders testified at these hearings on July 28, 2009: "From April to June 24th of this year, gasoline prices increased 54 days in a row, the longest streak on record dating back to 1996."[12]

The recent run up in crude oil and gasoline prices while the country is attempting to recover from the worst financial crisis since the Great Depression presents a dire threat that the financial back of the American consumer will yet be broken by further price spikes in everyday necessities, a phenomenon that will doubtless weigh down any potential economic recovery, leading to further and more sustained economic hardship.

The Overwhelming Consensus That Unchecked Excessive Speculation Has Caused Consumer Price Spikes In Energy and Food Staples. While there has been a debate over this point generally and at these hearings specifically, we agree with the great weight of independent and reasoned authority by many experts on[13], and observers of[14], these markets that outsized

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[9] Dinakar Sethuraman, *Goldman Sachs's Murti Raises Oil Forecast to $70*, BLOOMBERG NEWS, June 5, 2009, *available at* http://www.bloomberg.com/apps/news?pid=20601072&sid=aD0Z7MDwNvPQ&refer=energy (last visited Aug. 2, 2009).

[10] Energy Information Administration, U.S. Retail Gasoline Price data, *available at* http://www.eia.doe.gov/oil_gas/petroleum/data_publications/wrgp/mogas_history.html (last visited Aug. 2, 2009).

[11] Energy Information Administration. Heating oil prices are Spot price for New York Harbor No. 2 FOB, price data *available at* http://tonto.eia.doe.gov/dnav/pet/hist/rhonyhd.htm (last visited Aug. 2, 2009). Retail gasoline price data *available at* http://www.eia.doe.gov/oil_gas/petroleum/data_publications/wrgp/mogas_history.html (follow link for region, last visited Aug. 2, 2009).

[12] Testimony of Sen. Bernard Sanders, Before the Commodity Future Trading Commission on Energy Positions Limits and Hedge Exemptions, *available at* http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/hearing072809_sanders.pdf (last visited Aug. 2, 2009).

[13] *See*, *e.g.,* Edmund Conway, *George Soros: Rocketing Oil Price is a Bubble*, Daily Telegraph (May 27, 2008), *available at* http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/2790539/George-Soros-rocketing-oil-price-is-a-bubble.html (last visited Aug. 2, 2009) (quoting Mr. George Soros as stating "Speculation . . . is increasingly affecting the price"); Written Testimony of Michael Masters, *Hearing Before the Committee on Homeland Security and Governmental Affairs*, *U.S. Senate* 2 (May 20, 2008), *available at* http://hsgac.senate.gov/public/_files/052008Masters.pdf (last visited Aug. 2, 2009) (quoting Michael W. Masters as stating "Are Institutional Investors contributing to food and energy price inflation? And my unequivocal answer is YES"); Oral Testimony of Edward Krapels, Hearing Before the Committee on Energy and Commerce Subcommittee on Oversight and Investigations, U.S. House of Representatives, (June 23, 2008) (quoting Mr. Edward Krapels as stating "I think the amount of speculation is really substantial [within the crude oil market.]"); Oral Testimony of Roger Diwan, Hearing Before the Committee on Energy and Commerce Subcommittee on Oversight and Investigations, U.S. House of Representatives, (June 23, 2008) (quoting Mr. Roger Diwan,

excessive speculation within the physical derivatives markets has caused unnecessary volatility, including unnecessary and substantial price increases that consumers pay for everyday staples.

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responding to Rep. Whitfield's question: So you're saying if we adopt these regulatory changes, we could almost cut the retail price of gas in half in a relatively short period of time? "I don't know how quickly it takes to get prices down, but it's clear that prices will reflect closer the marginal cost of producing oil."); Alejandro Lazo, Energy *Stocks Haven't Caught Up With Oil Prices*, WASH. POST, Mar. 23, 2008, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/03/21/AR2008032103825.html (last visited Aug. 2, 2009) (quoting Mr. Fadel Gheit as stating, "The largest speculators are the largest financial companies."); Michelle Foss, United States Natural Gas Prices to 2015, 34 (2007), *available at* http://www.oxfordenergy.org/pdfs/NG18.pdf (last visited Aug. 2, 2009) (asserting "The role of speculation in oil markets has been widely debated but could add upwards of $20 to the price per barrel."); Tim Evans, Citi Futures Perspective: PM Energy News & Views, at 2 (July 3, 2008) (quoting "With the latest push to the upside, we see the crude oil market becoming even more completely divorced from any connection to fundamental factors and becoming even more obsessed with the simple question, How high can it go?"); Advantage Business Media, *Economist Blames Subsidies for Oil Price Hike*, Chem.Info (2008), *available at* http://www.chem.info/ShowPR.aspx?PUBCODE=075&ACCT=0000100&ISSUE=0609&ORIGRELTYPE=DM&RELTYPE=PR&PRODCODE=00000&PRODLETT=M&CommonCount=0 (last visited Aug. 2, 2009) (quoting Dr. Michelle Foss as stating "We have an overpriced commodity, and this is going to be around for a while."); Kenneth N. Gilpin, *OPEC Agrees to Increase Output in July to Ease Oil Prices*, N.Y. TIMES (June 3, 2004) *available at* http://www.nytimes.com/2004/06/03/business/03CND-OIL.html?ex=1401681600&en=5dbd50c5b369795b&ei=5007&partner=USERLAND (last visited Aug. 2, 2009) (quoting Mr. Kyle Cooper as stating, "There is not a crude shortage, which is why OPEC was so reluctant to raise production."); Upstream, *Speculators 'not to blame' for Oil Prices*, UpstreamOnline.com (April 4, 2008), *available at* http://www.upstreamonline.com/live/article151805.ece (last visited Aug. 2, 2009) (quoting Mr. Sean Cota as stating, "It has become apparent that excessive speculation on energy trading facilities is the fuel that is driving this runaway train in crude prices"); Mike Norman, *The Danger of Speculation*, FoxNews.com, *available at* http://www.foxnews.com/story/0,2933,166038,00.html (last visited Aug. 2, 2009) (Mr. Norman stating "Oil prices are high because of speculation, pure and simple. That's not an assertion, that's a fact. Yet rather than attack the speculation and rid ourselves of the problem, we flail away at the symptoms."); International Monetary Fund, Regional Economic Outlook: Middle East and Central Asia 27-28 (May 2008) ("Producers and many analysts say it is speculative activity that is pushing up oil prices now. Producers in particular argue that fundamentals would yield an oil price of about US $80 a barrel, with the rest being the result of speculative activity."); *see also* Neil King Jr., *Saudi Arabia's Leverage In Oil Market Is Sapped*, WALL STREET J. (June 16, 2008), *available at* http://online.wsj.com/article/SB121355902769475555.html?mod=googlenews_wsj (last visited Aug. 2, 2009) (quoting Saudi Oil Minister Ali Naimi as saying skyrocketing oil prices were "unjustified by the fundamentals" of supply and demand); Gordon Brown and Nicolas Sarkozy, *We Must Address Oil-Market Volatility*, Wall St. J., July 8, 2009, *available at* http://online.wsj.com/article/SB124699813615707481.html (last visited July 31, 2009); Michael W. Masters & Adam K. White, *How Investors Are Driving Up Food and Energy Prices*, July 31, 2008, *available at* www.accidentalhuntbrothers.com (last visited Aug. 2, 2009); Michael W. Masters & Adam K. White, *Index Speculators Have Been a Major Cause of the Recent Drop in Oil Prices*, Sept. 10, 2008, *available at* www.accidentalhuntbrothers.com (last visited Aug. 2, 2009).

[14] INTERNATIONAL MONETARY FUND, REGIONAL ECONOMIC OUTLOOK: MIDDLE EAST AND CENTRAL ASIA, 27-28, (May 2008) ("Producers and many analysts say it is speculative activity that is pushing up oil prices now. Producers in particular argue that fundamentals would yield an oil price of about US $80 a barrel, with the rest being the result of speculative activity."), *available at* http://www.imf.org/external/pubs/ft/reo/2008/MCD/eng/mreo0508.pdf (last visited Aug. 2, 2009). *See also* Neil King Jr., *Saudi Arabia's Leverage In Oil Market Is Sapped*, WALL STREET J. (June 16, 2008), *available at* http://online.wsj.com/article/SB121355902769475555.html?mod=googlenews_wsj (last visited July 8, 2008) (quoting Saudi Oil Minister Ali Naimi as saying skyrocketing oil prices were "unjustified by the fundamentals" of supply and demand); Mahar Chmaytellin, *OPEC Calls for Curbing Oil Speculation, Blames Funds (Update2)*, BLOOMBERG, Jan. 28, 2009, *available at* http://www.bloomberg.com/apps/news?pid=20601013&sid=aVRKbFhcfdKM (last visited Aug. 2, 2009).

Whatever debate remains over the question whether excessive speculation (and not supply/demand factors) have been a principal source of price volatility should be put to rest completely by the last of a series of three bipartisan staff reports of the Senate Permanent Subcommittee on Investigations ("PSI"), which on June 24, 2009 (with the express endorsement of both PSI Chairman Senator Carl Levin and Ranking Member Senator Tom Coburn[15]) demonstrated conclusively that:

- "[o]ver the past four years . . . increases in wheat prices were nearly as steep as the increases in the price of oil,"[16] during which period wheat prices rose "to record heights"[17];
- there is "significant and persuasive evidence that the large number of wheat futures contracts (long open interest) held by commodity index traders is a primary reason for the pricing problems in the wheat market . . including . . . the disconnect between wheat futures prices and cash market fundamentals . . . during 2008;[18]"
- "commodity index instruments were, in essence, *speculative bets*;"[19]and
- "[t]he total value of the *speculative* investments in commodity indexes has increased an estimated tenfold in five years, from an estimated $15 billion in 2003, to around $200 billion by mid-2008."[20]

The PSI *Wheat Report* concluded "that the activities of the commodity index traders, in the aggregate, constituted 'excessive speculation' in the wheat market under the Commodity Exchange Act" and "that the CFTC [must] phase out existing exemptions and waivers that allow some index traders to operate outside of trading limits designed to prevent excessive speculation."[21]

Indeed, on March 24, 2009, 184 U.S. based and international human rights and hunger relief organizations anticipated the kind of analysis found in the PSI *Wheat Report* by sending a

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[15] *See* Press Release, Sen. Carl Levin, Investigations Subcommittee Releases Levin-Coburn Report on Excessive Speculation in the Wheat Market (June 24, 2009), *available at* http://levin.senate.gov/newsroom/release.cfm?id=314947 (last visited Aug. 2, 2009); Jerry Hagstrom, *Report: Commodity index trade should be limited*, AGWEEK, June 29, 2009, *available at* http://www.agweek.com/articles/?article_id=14488&property_id=41 (last visited Aug. 2, 2009) .

[16] PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, EXCESSIVE SPECULATION IN THE WHEAT MARKET (June 24, 2009) at 37 [hereinafter "Wheat Report"].

[17] *Id.* at 39.

[18] *Id.* at 120

[19] *Id.* at 94 (emphasis added).

[20] *Id.* at 5 (emphasis added).

[21] *Id.* at 2-3.

letter to President Obama urging the "re-regulat[ion of] the food and energy commodities futures markets to remove excessive speculation that has so clearly increased price volatility in the last few years."[22] The letter also noted that "[b]etween May 2007 and March 2008, hard red winter wheat rose 137 percent, from July 2007 and June 2008 corn prices rose 98 percent. Other food commodities rose in a similar fashion putting daily sustenance out of reach for 200 million more people in the developing world. Families used to buying kilos of food were only able to buy cups of the same food items. People went hungry. Children stopped growing for months at a time, while others perished. . . ."[23] The letter also notes that the sudden and deep subsequent food price decline "forced farmers in the developing world and the United States from their farms."[24]

The Historical Recognition That Excessive Speculation Destroys Fair and Orderly Futures Markets. One of the fundamental purposes of futures contracts is to provide price discovery in the "cash" or "spot" markets.[25] Those selling or buying commodities in the "spot" markets rely on futures prices to judge amounts to charge or pay for the delivery of a commodity.[26] Since their creation in the agricultural context decades ago, it has been widely understood that, unless properly regulated, futures markets are easily subject to distorting the economic fundamentals of price discovery (*i.e.*, cause the paying of unnecessarily higher or lower prices) through, *inter alia*, excessive speculation.[27]

As the 1935 Report of House Agriculture Committee stated: "The fundamental purpose of the measure [*i.e.*, what was to become the Commodity Exchange Act of 1936 ("CEA")] is to insure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity which *too often demoralize the markets to the injury of producers and consumers and the exchanges themselves*."[28]

Indeed, President Roosevelt, when introducing what became the CEA in 1934 said: "[I]t should be our national policy to restrict, as far as possible, the use of these exchanges for purely

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[22] Letter to President Obama from domestic and international human rights and hunger relief organizations, *available at* http://www.foodfirst.org/files/pdf/Food%20Speculation%20Coalition%20Letter%20to%20President%20Obama%20.pdf (last visited Aug. 2, 2009).
[23] *Id*. (emphasis added).
[24] *Id*. at 1.
[25] The Economic Purpose of Futures Markets and How They Work, COMMODITY FUTURES TRADING COMMISSION, http://www.cftc.gov/educationcenter/economicpurpose.html (last visited Aug. 2, 2009).
[26] *See* Platts Oil Pricing and Market-on-Close Methodology Explained, Platts (July 2007) at 3, *available at* http://www.platts.com/IndustrySolutionPapers.aspx (last visited Aug. 2, 2009).
[27] *See*, *e.g.*, Jonathan Ira Levy, *Contemplating Delivery: Futures Trading and the Problem of Commodity Exchange in the United States*, *1875-1905*, AMERICAN HISTORICAL REVIEW 307 (2006) ("'[T]he man who managed or sold or owned those immense wheat fields has not as much to say with the regard to the price of the wheat that some young fellow who stands howling around the Chicago wheat pit could actually sell in a day'"(quoting *Fictitious Dealings in Agricultural Products: House Comm. on Agric. Committee Hearing Reports* (1892)).
[28] Report No. 421, U.S. House of Representatives 74th Cong, Accompanying the Commodity Exchange Act, March 18, 1935 (emphasis added).

speculative operations."[29] In this regard, the House Agriculture Committee then stated: "This bill authorizes the Commission . . . to fix limitations upon purely speculative trades . . ."[30]

As the telling colloquy between Chairman Gensler and General Counsel Dan M. Berkovitz at the July 28, 2009 hearing so accurately reflected, the Commodity Exchange Act today, 74 years later, continues to provide that it is the duty of the Commission to guard against "excessive speculation" that destabilizes markets under this agency's jurisdiction.

Congress Has Required The CFTC To Limit Excessive Speculation That Burdens Interstate Commerce. Accordingly, § 4a(a) of the CEA provides:

> "*Excessive* speculation in any commodity . . . 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* . . . fix such limits on the amounts of trading which may be done [relating to] such commodity. . . as the Commission finds . . . necessary to diminish . . . such burden."[31]

As Chairman Gensler said in his opening statement: "Congress gave the CFTC an important tool [to deal with excessive speculation] – position limits – *and they directed us to use them*."[32]

The Difference between Speculation That Aids Market Liquidity and Excessive Speculation That Destroys Markets. Embedded within that overwhelming support pinpointing *excessive* speculation as the culprit in causing unfair and dysfunctional markets is the fundamental understanding that futures markets are designed not to raise capital for, or provide lending to, business interests.[33] The entire rationale of these markets is to provide risk shifting vehicles to commercial producers and consumers. The tension between commercial producers and consumers trying to achieve fair prices for the sale and/or purchase of physical commodities through the public transparent hedging process moors these price discovery futures markets to economic fundamentals and, correspondingly, ensures fair market prices to the ultimate consumers of these commodities.

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[29] President Franklin D. Roosevelt, Message to Congress, February 9, 1934.
[30] Report No. 421, U.S. House of Representatives 74th Cong., Accompanying the Commodity Exchange Act, March 18, 1935.
[31] 7 U.S.C. § 6a(a) (emphasis added).
[32] Opening Statement of Chairman Gary Gensler, Hearing of the Commodity Futures Trading Commission, July 28, 2009, *available at* http://www.cftc.gov (last visited Aug. 2, 2009) (emphasis added).
[33] Support for observations within this and the succeeding two paragraphs of this testimony can be found, *inter alia*, in the within the Wheat Report at pages 50-75, where there is a thorough and scholarly explanation of the purpose and beneficial hedging role of properly functioning futures markets, including observations about the proper role of speculation and the controls that must be imposed by the CFTC on speculation to keep it from becoming "excessive" and dysfunctional.

Speculators have a role to play in the hedging function *when* they are needed to ensure that the market has liquidity, *i.e.,* physical hedgers are almost always not numerous enough to ensure that contracts may be traded expeditiously among them, thereby ensuring much needed liquidity within these markets. However, it was a fundamental axiom within President Roosevelt's 1934 message to Congress urging the passage of the CEA that speculation cannot be "excessive," because, as the farmers learned to their dismay in the early 20th century, too much speculation, *i.e.*, more speculation than is needed to provide hedgers with liquidity, will unmoor the market from the competing tensions between consumers and producers when there is an overriding speculative influence.

Speculators' motivations do not include ensuring fair prices. They are simply betting on the direction of the market and their sole interest is that the markets go as high or as low as possible in support of their betting strategy. To the extent the speculator is providing liquidity for physical hedgers, the speculator is serving a public interest by assisting in the hedging function (*i.e*., providing enough counterparties for physical hedgers) even though it is pocketing gains.

When speculation is "excessive," however, those market "bets," as shown in PSI's *Wheat Report* described above, unmoor the market from fundamentals, causing prices to vary from supply/demand principles, and, correspondingly, driving the hedger from the markets because of volatility and unpredictability.

If commercial interests cannot hedge in a fair and orderly market, they and their ultimate consumers, the public at large, are left to the mercy of extreme volatility that undercuts the hedging function. A contract market dominated by speculators changes the market from one that constructively shifts risk into a casino-like atmosphere consisting of bets on market direction unmoored from real world market responsibilities.

Commercial Hedgers Leaving Futures Markets Because of the Instability Caused by Excessive Speculation. Congressman Bart Stupak, Chairman of the House Energy Committee's Subcommittee on Oversight and Investigations and a leader in the recent House passage of strict new futures market reregulation,[34] has analyzed data his Subcommittee requested from this Commission on the degree of speculation in the crude oil futures markets. In his testimony last week, he analyzed that data as follows:

> "In 2000, physical hedgers -- businesses such as airlines and trucking companies that need to hedge to ensure a stable price of fuel in future months -- accounted for 63 percent of the oil futures market. Speculators accounted for 37 percent. By

[34] *See* Dawn Kopecki, *Derivatives Regulation Fight Lurks in US Climate Bill*, BLOOMBERG.COM, June 26, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=a.9mZUnQbY5c (last visited Aug. 2, 2009); Press Release, Congressman Bart Stupak, Stupak Includes Market Protections in American Clean Energy and Security Act (May 21, 2009), *available at* http://www.house.gov/list/speech/mi01_stupak/morenews/20090521carbon.html (last visited Aug. 2, 2009).

April 2008, physical hedgers' share of the same market had dropped to 29 percent, with speculators now controlling an astonishing 71 percent of the oil market. The market was taken over by swap dealers and speculators . . ."[35]

Chairman Stupak's subcommittee's analysis of swaps dealers' and index traders' "positions for crude oil, heating oil, natural gas, and gasoline" also showed "that speculators . . . held 60 percent of the open interest in natural gas markets on June 30, 2008, and 75 percent of the [WTI] crude oil market."[36]

In short, Chairman Stupak's analysis demonstrates that commercial crude oil hedgers are abandoning "hedging," thereby leaving themselves and their customers to the mercy of extreme market volatility. In the place of commercial hedging, these markets have become casinos for those who want to bet on market direction. It has never been the purpose of Congress to have futures markets become gambling combines.

The Beneficial Effects of the CFTC's New Data Collection Program. In June and July, 2008 the Commission issued a special call to swaps dealers and index traders regarding their activity in the unregulated or over-the-counter ("OTC") physical derivatives markets in response to a wave of concern, most of which emanated from Congress[37], that speculative activities in unregulated derivatives markets had an undue and excessive burden on the price of everyday necessities for the average American. In September 2008, the Commission issued a "Staff Report on Commodity Swap Dealers and Index Traders," that, in contrast to the great weight of countervailing authority, supported the concept that supply/demand principles, rather than excessive speculation, was the proximate cause of recent volatility in physical commodity markets.

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[35] Testimony of Rep. Bart Stupak, Before the Commodity Future Trading Commission on Energy Positions Limits and Hedge Exemptions at 3, *available at* http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/hearing072809_stupak.pdf (last visited Aug. 2, 2009).

[36] *Id.*

[37] *See, e.g.*, Wheat Report, *supra* note 16, at 43-44 for a listing of bipartisan legislation introduced to stem excessive speculation in the physical derivatives markets. The House Agriculture Committee drafted on a day's notice and supervised the June 26, 2008 passage by a vote of 402 -19 emergency legislation that would have required the CFTC to implement emergency procedures in the crude oil futures markets to bring down the then sky rocketing price of gasoline, heating oil, and crude oil. David Cho, *House Passes Bill Bolstering Oil Trade Regulator*, WASH. POST, June 27, 2008, at D8 *available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/06/26/AR2008062604005.html (last visited Aug. 2, 2009). The Committee then drafted and supervised the passage by a 283-133 September 18, 2008 vote of the Commodity Markets Transparency Act of 2008, which was designed to bring transparency and accountability to the OTC energy markets, thereby stifling excessive speculation and unnecessarily high prices for America's energy needs. Commodity Markets Transparency and Accountability Act, 110th Cong. (2008) *available at* http://thomas.loc.gov/cgi-bin/bdquery/z?d110:HR06604:@@@R (last visited Aug. 2, 2009).

As Chairman Stupak has said in these hearings, that September 2008 CFTC staff report has been the source of controversy.[38] It appears, however, that the controversy over the report will soon become moot. The Commission announced on July 7, 2009 that, rather than limit its information on speculative trading in unregulated physical derivatives markets to what was collected last summer, it would, "through [its] special call authority, . . . continue to collect and report data from swaps dealers and index investors," which will soon be reported quarterly through its Commitment of Traders ("COT") reports.[39]

When that data becomes publicly available, it will provide grounds for judging the accuracy and conclusions of the CFTC's September 2008 staff report. Based on all other reliable and objective reporting in this area, including the Senate's June 24, 2009 PSI *Wheat Report*, it can be anticipated that those weekly reports will corroborate the existing and substantial evidence that excessive speculation has unnecessarily and substantially driven up the cost of Americans' basic necessities; and that that excessive speculative activity needs to be brought under strict regulatory controls.

The Senate Permanent Subcommittee on Investigation's Prior Findings on Excessive Speculation in Energy Futures Markets. In this regard, the Senate PSI reports of 2006 and 2007[40] have also concluded that the speculative derivatives transactions of large financial institutions and wealthy investors had needlessly and substantially driven up the price of energy commodities over that which economic fundamentals would dictate. For example, the second of those reports discussed the dominance of a single speculative hedge fund, Amaranth, in the natural gas futures markets as follows:

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[38] *See* Written Testimony of Congressman Bart Stupak, *Commodity Futures Trading Commission Hearing on Energy Position Limits and Hedge Exemptions*, 3 (July 28, 2009), *available at* http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/hearing072809_stupak.pdf (last visited Aug. 2, 2009) (noting that "questions [were] raised by Commissioner Bart Chilton and others regarding the accuracy and conclusions of the September 2008 staff report.); Prepared Statement of Michael W. Masters, Managing Member/Portfolio Manager, Masters Capital Management, LLC., Saint Croix, VI, *Hearing Before the Committee on Energy and Natural Resources Subcommittee on Energy, U.S. Senate*, 14-15 (Sept, 16, 2008), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-110shrg670/pdf/CHRG-110shrg670.pdf (last visited Aug. 2, 2009) (stating that the staff report "represents a step backward" and questioning the staff report's "transparency, accuracy and consistency"); Statement of Subcommittee on Energy Chairman Byron L. Dorgan, *Hearing Before the Committee on Energy and Natural Resources Subcommittee on Energy, U.S. Senate*, 53-54 (Sept. 16, 2008), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-110shrg670/pdf/CHRG-110shrg670.pdf (last visited Aug. 2, 2009) (questioning the staff report's accuracy).

[39] Statement of Chairman Gary Gensler on Speculative Position Limits and Enhanced Transparency Initiatives, CFTC, July 7, 2009, *available at* www.cftc.gov/stellent/groups/public/.../genslerstatement070709.pdf (last visited Aug. 2, 2009).

[40] PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, THE ROLE OF MARKET SPECULATION IN RISING OIL AND GAS PRICES: A NEED TO PUT THE COP BACK ON THE BEAT (June 27, 2006) [hereinafter June 2006 Report]; PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET (June 25, 2007) [hereinafter June 2007 Report].

> "[T]he CFTC defines a 'large trader' . . . in the natural gas market as a trader who holds at least 200 contracts; . . . Amaranth held as many as 100,000 natural gas contracts in a single month, representing 1 trillion cubic feet of natural gas, or 5 % of the natural gas used in the entire United States in a year. At times Amaranth controlled 40% of all of the outstanding contracts on NYMEX [(one of the two major exchanges on which natural gas is traded in the U.S.)] for natural gas in the winter season (October 2006 through March 2007), including as much as 75% of the outstanding contracts to deliver natural gas in November 2006."[41]

According to PSI, Amaranth so dominated the natural gas markets that by late July 2006 the futures price of the October natural gas contract was at a yearly high of $8.45 MMBtu; yet, after Amaranth failed in September 2006, the futures price, without any change in supply/demand fundamentals, dropped "to just under $4.80 per MMBtu . . ., the lowest level for that contract in two and one-half years. . . The Electric Power Research Institute described this price collapse as 'stunning . . . one of the steepest declines ever.' . . ."[42]

Both of these earlier Senate PSI Reports were premised upon findings that excessive speculation unnecessarily ran up the prices of essential commodities, because the trading was done on exchanges which were *at that time* not subject to CFTC jurisdiction and thus the CFTC could not impose position limits on that kind of activity. Indeed, those reports led to legislative and CFTC- based reforms that brought some of those exchanges within a CFTC regulated format, including the imposition of speculative position limits, *e.g.*, the Farm Bill Amendments of 2008 recently allowed the CFTC to bring previously unregulated natural gas futures contracts under its direct oversight; and a June 17, 2008 CFTC staff imposition on ICE Futures Europe of further conditions of operation within the U.S. calling for increased transparency of, and speculation limits on, that exchange's trading of WTI crude oil futures contracts.

The Recent Senate Subcommittee on Permanent Investigation's Findings on Excessive Speculation and Record High Prices in the Wheat Markets. As described above, on June 24, 2009, the Senate PSI issued its bipartisan staff report on "Excessive Speculation in the Wheat Market." As we have noted, the PSI found therein that unchecked excessive speculation by passive commodity index funds led to substantial price dysfunctions within the wheat markets, including the price of wheat climbing by mid-2008 to "record heights" and "then falling sharply during the latter half of 2008."[43]

<u>The Role of Passive Commodity Index Speculation.</u> The PSI report explains that commodity indexes offer investors the purchase of a "financial instrument whose value is linked to a commodity index enabl[ing] an investor to get broad exposure to commodities without

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[41] June 2007 Report, *supra* note 40, at 2.
[42] *Id*. at 1-2 (internal citations omitted).
[43] Wheat Report, *supra* note 16, at 37.

having to actually purchase quantities of each commodity or manage a portfolio of commodity investments."[44]

While this testimony cannot replicate the detail and nuance of the PSI description of commodity index investing, it is enough to quote the following: "The value of a commodity index is derived from calculating the total value of a specified 'basket' of commodities. Each commodity within the basket is assigned a specified weight, or percentage, and the value of each commodity within the index"[45] and the value of each basket is dependent upon the price of commodity futures traded on futures exchanges.

Commodity Index Swaps. A chart of the popular S&P Goldman Sachs Commodity Index ("GSCI") as of March 2009 shows, for example, that crude oil futures make up over 44% of that commodity index, and all energy commodities over 65%, while agricultural products make up about 18% of the index with Chicago wheat (CME wheat) comprising 5.2% of the index on its own.[46] The *Wheat Report* states: "Financial institutions have devised several types of financial instruments to enable investors to gain exposure to the value of a commodity index."[47] The Report further notes: "The most common type of commodity index instrument is a . . . 'swap' whose return is based upon the performance of a specified index. . . If the value of the commodity index increases, the value of the swap to the purchaser will increase by a corresponding amount."[48] The swaps are sold by swaps dealers "'over the counter,' outside of the statutory and regulatory framework that applies to futures exchanges."[49]

Because most investors in commodity index swaps are going "long," *i.e.*, they wish to profit from an increase in the basket of commodities, the swaps dealer which holds the other side of the transaction is "short" the basket of commodities and, if not hedged, it will lose money if the commodities gain in value. To eliminate that exposure to their swaps customers, "swaps dealers frequently use the futures markets for the purpose of obtaining . . . hedges or offsets,"[50] *i.e.*, laying off the risk to their customers by buying offsetting futures contracts on the futures exchanges reflecting commodity holdings in the index "basket."

Commodity Index Exchange Traded Funds and Exchange Traded Notes. The two other types of commodity index instruments are exchange traded funds ("ETFs") and exchange traded notes ("ETNs"). ETFs are sold to investors as "shares on a stock exchange. . . .The ETF is structured so that the value of the ETF shares . . . reflect[s] the value of the commodity index

[44] *Id*. at79.
[45] *Id.* at 79-80.
[46] *Id.* at 81.
[47] *Id.* at 83.
[48] *Id.* at 83.
[49] *Id.* at 83.
[50] *Id.* at 84.

upon which they are based."[51] Further, "[t]o provide value to their shares, commodity-based ETFs hold the various futures contracts whose values are used to compute the index value."[52]

As the *Wheat Report* states: "Commodity-based ETNs are designed and sold by banks and other financial institutions to permit retail investors to purchase shares of a debt security whose price is linked to that of a commodity index. Upon maturation of the note, the issue of the ETN promises to pay the holder of each share of the note the value of [the] commodity index."[53]

A list of the largest commodity ETFs and ETNs as of April 30, 2009, as well as related financial data, can be found on page 88 of the PSI *Wheat Report*.

For the same reason that swap dealers marketing commodity swaps indexes need to lay off risk on futures exchanges, ETFs and ETNs similarly seek access to futures markets in direct relationship to the size of the commodity index fund to lay off the risk of their commodity-based securities or debt sales to their customers.

<u>The Phenomenal Growth of Commodity Indexes.</u> Investments in commodity indexes are "purchased mainly by financial institutions, insurance companies, pension funds, foundations, hedge funds and wealthy individuals[.]"[54] According to the *Wheat Report*, the value of these investments "has grown more than tenfold in five years, from an estimated $15 billion in 2003, to at least $200 billion in mid-2008. The purchases of these index instruments have resulted in the injection of billions of dollars in passive, long investments into the agricultural, energy, and metals futures markets."[55]

The *Wheat Report* refers to articles appearing in 2006 indicating "that purchases of commodity index instruments were, in essence, *speculative bets* on the structure of the commodities futures markets rather than a risk-free technique for portfolio diversification."[56] Another analyst "left his readers with the following advice: 'The next time someone tries to sell you a commodities fund based on the Goldman Sachs Commodities Index, smile and say, 'Sorry, but I'm from Earth, and you're from planet *I Love Lucy*. Let's revisit this discussion in an alternate universe.'"[57]

<u>The Way Position Limits Control Excessive Speculation.</u> As noted above, under § 4a(a) of the CEA, the CFTC has a statutory mandate to prevent excessive speculation that causes an undue burden on the interstate commerce. The regulatory tool used to control that speculation that is "excessive" is the imposition on the participation of such speculation by "limits" on

[51] *Id.* at 84.
[52] *Id.* at 86.
[53] *Id.* at 86.
[54] *Id.* at 76.
[55] *Id.* at 76 (emphasis added).
[56] *Id.* at 94 (emphasis added).
[57] *Id.* at 102 (emphasis added and citations omitted).

"positions" such speculative traders may take in the affected contract markets for the physical commodity in question. "For several markets (corn, oats, wheat, soybeans, soybean oil, soybean meal, and cotton) the limits are determined by the Commission [itself] and set out in . . . regulations. . . .For other markets, the limits are determined by the [regulated] exchanges."[58] The CFTC (and then Congress) has authorized exchanges to substitute accountability levels for position limits, but has strongly encouraged keeping those limits on physical futures in spot months.[59] "Accountability levels" are not hard limits; they are statistical trading signals given to the exchanges indicating that the speculative trading should be monitored.

Position limits are a "hard" limit on the number of futures contracts a trader can hold. There are three kinds of limits: spot month limits (applying only to contracts held in the month a contract expires); single month limits (applying to those monthly contracts other than those in the spot month); all-months combined limits (a limit on the total number of contract across all contract months).[60] The CFTC has imposed all three kinds of position limits on the agricultural commodities over which it now asserts direct position limit setting authority, including wheat.[61]

<u>Exemptions from Position Limits.</u> Section 4a(c) of the CEA grants an exemption from position limits for "bona fide hedging transactions," leaving to the CFTC the discretion to define that term "consistent with the purposes" of the CEA to "permit" futures market users "to hedge their legitimate anticipated business needs . . . ."

As the PSI aptly states: "While there has been longstanding, broad consensus on the need to grant hedge exemptions [from speculative position limits] for commodity producers, merchants, and end users to manage price risks, granting similar exemptions to *financial* firms . . to manage their *financial* risks has been the subject of longstanding debate and controversy."[62]

Based on the interpretation of various Congressional *reports* (but not statutory directives), the CFTC in 1987 "issued a new *interpretation* of bona fide hedge transactions to permit exchanges to grant hedge exemptions for various [*financial*] risk management transactions."[63]

<u>Hedge Exemptions from Position Limits for Commodity Index Funds.</u> Pursuant to that 1987 interpretation, "in 1991 the [CFTC] staff granted a . . . hedge exemption to a swap dealer

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[58] CFTC, *Speculative Limits*, CFTC homepage, *available at* http://www.cftc/gov/industryoversight/marketsurveillance/speculativelimits.html (last visited Aug. 2, 2009). *See also*, 17 C.F.R. § 150.5.
[59] Testimony of General Counsel Dan M. Berkovitz, Before the Commodity Future Trading Commission on Energy Positions Limits and Hedge Exemptions at 13-14, *available at* http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/berkovitzstatement072809.pdf (hereinafter "Berkovitz Testimony"). *See also* 7 U.S.C. §7(d)(3) and 17 C.F.R. Part 38, Appendix B.
[60] 15 C.F.R. § 150.1 (a)-(c).
[61] *Id.* § 150.2.
[62] Wheat Report, *supra* note 16, at 74 (emphasis added).
[63] Berkovitz Testimony, *supra* note 59, at 18 (emphasis added).

who was seeking to manage price risk on its books as a result of swaps it planned to enter into with various investors [in] commodity indexes. Similar hedge exceptions were subsequently granted . . . where the futures positions offset risks related to swaps or similar OTC positions involving both individual commodities and commodity indexes.64 On two occasions, CFTC staff has approved no action letters to managers of commodity index ETFs from the CFTC established position limits for agricultural commodities.

Commodity Index Funds Exemptions from Position Limits Lead to Their Dominance in the Wheat Futures Markets. The CFTC has, since 2005, granted hedge exemptions for four swaps dealers for wheat futures trading on the Chicago futures exchange to allow those dealers to hedge their financial exposure to their commodity index swaps investors. The *Wheat Report* states: "Those exemptions permit the swaps dealers to hold up to 10,000, 17,500, 26,000, and 53,000 wheat futures contracts."[65] Adding CFTC staff hedge exemptions granted to ETFs, those "six index traders . . . hold a total of up to almost 130,000 wheat futures contracts in any single month and in all months combined" measured against an allowable limit of 39,000 contracts in the absence of the hedge exemptions.[66]

Thus, those six commodity index traders "may have held as much as 60% of the long open interest in" CME wheat futures contracts.[67] Further, the *Wheat Report* states: "If each swap dealer were restricted to holding no more than 6,500 wheat futures contract at any given time [*i.e.*, limited to the spot month CFTC-established position limit] these swaps dealers would have had to find another way to offset their financial exposure to the commodity index swaps they sold, or to assume the outright risk from those swaps."[68] As other experts have concluded, there may be no other "way" that substitutes for the purchase of offsetting futures contracts.

Senate PSI Finds Excessive Speculation from Commodity Index Funds Burdens The Wheat Markets. Accordingly, PSI found that the excessive speculation in the wheat futures market caused "unwarranted changes and unreasonable fluctuations" in the price of wheat futures contracts, and thus an "undue burden on interstate commerce." [69] It therefore recommended phasing out existing hedge exemptions for wheat futures for index traders and the possible consideration of reducing position limits on those markets from 6,500 to 5,000 contracts. It also recommended that the CFTC study other agricultural commodity markets and to strengthen data collection of the impact of index traders on non-agricultural commodities, "especially crude oil and other energy commodities."[70]

[64] *Id*. at 18.
[65] Wheat Report, *supra* note 16, at 105.
[66] *Id.* at 105.
[67] *Id.* at 106.
[68] Wheat Report, *supra* note 16, at 104, n. 187.
[69] *Id.* at 157.
[70] *Id.* at 16.

Excessive Speculation Has Caused Price Volatility and Otherwise Wreaked Havoc on Food and Energy Prices. Based on the PSI's *Wheat Report* and the great weight of accumulated Congressional[71], physical hedgers', consumer, and academic concerns expressed on a worldwide basis about excessive speculation, there can be no reasonable doubt about three salient facts:

> (1) the physical derivatives markets are now very likely overrun by speculation (*i.e*., bets about the direction of those markets unmoored from market fundamentals) that far exceeds liquidity needs;
>
> (2) that, as a result, physical futures markets have become so unstable and volatile that physical hedgers are rapidly abandoning the hedging function of exchange traded derivatives, thereby often leaving themselves and their consumers to the mercy of unpredictable and volatile prices; and
>
> (3) that, as result of the prior two factors, prices for Americans' (and indeed, especially in the case of food, the world's) basic necessities have been subject to crippling and unpredictable volatility which has a bias toward establishing on a repeated and ever increasing basis world record high prices for food staples, oil, gasoline, heating oil and natural gas.

Indeed, Congress has been so concerned about these kinds of dysfunctions in the natural gas and crude oil futures markets, it required the Federal Energy Regulatory Commission (in 2005) and the Federal Trade Commission (in 2007), respectively, to share jurisdiction with the Commission in oversight of these derivative markets to investigate Congressional concerns that the spot prices for natural gas and energy are being adversely affected by excessive speculation in natural gas and crude oil derivatives markets.[72]

The Commission Must Assert Position Limit Authority for All Physical Futures Markets within Its Jurisdiction. Given the powerful nature of the position limit tool provided to the Commission by Congress to prevent excessive speculation in physical futures markets, the time has come for the Commission to take back from the exchanges their authority to set position limits on non-agricultural physical futures trading. Moreover, the Commission must carefully

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[71] Congress was so concerned about excessive speculation that it required FERC in 2005 and the FTC in 2007 to share jurisdiction of futures markets with the CFTC for the natural gas and crude oil markets, respectively. *See* Written Testimony of Professor Michael Greenberger, *Energy Market Manipulation and Federal Enforcement Regimes, Hearing Before the U.S. Senate Comm. on Commerce, Science, and Transportations* 16 (June 3, 2008), *available at* http://www.michaelgreenberger.com/files/June_3_2008_testimony.pdf (last visited Aug. 2, 2009). Further, on July 25, 2008, Senator Reid brought to the Senate floor a bill that would impose across the board position limits ("aggregate position limits"). The bill received 50 of 93 Senate votes, but not enough to sustain cloture. *See* Coral Davenport, Senate GOP Blocks Ending Energy Bill Debate, CQ.COM, July 25, 2008, *available at* http://public.cq.com/docs/cqt/news110-000002926452.html (last visited Aug. 2, 2009).

[72] *See supra* note 71.

weigh the effectiveness of the existing position limits for those agricultural products the Commission itself now sets. Also, in determining whether to deploy as its own those spot month position limits presently set by the exchanges, the Commission must carefully examine the effectiveness of those limits as now set. As these hearings have already demonstrated, the Commission clearly has existing legislative authority to take all of these actions.

As I understand it, the CME has now acknowledged the need for hard position limits for "single months" and "all months" combined. We applaud that action; but for *now all three types of "hard" limits must be set by the Commission itself.*

Exemptions from Position Limits Should Not Be Granted to Hedge Financial Risk. Both the Chairman, in his opening statement, and the PSI *Wheat Report* have identified the question whether the statutory definition of "bona fide hedging transaction" (*i.e.*, a transaction not subject to position limits) should include the hedging of financial risk, *e.g.*, index commodity swap traders offsetting their exposure to their swaps customer by buying corresponding physical futures contracts on a regulated exchange.)

For purposes of wheat futures, the PSI *Wheat Report* recommends the phasing out of hedge exemptions of this nature for commodity index traders. Again, it must be remembered that only 5.2% of the Goldman Sachs Commodity Index, for example, is composed of Chicago wheat. The other 94.8% of the physical commodities referenced within that index similarly require hedging by commodity index traders in the corresponding agricultural, crude oil, and natural gas futures contracts. The *Wheat Report*'s findings on commodity index trading on wheat prices corroborates the abundance of information described above that price spikes in other physical commodities trace their origins to commodity index hedge exemptions from position limits on all exchange traded futures markets that correspond to the commodity index product makeup.

Until the Commission is convinced that these physical futures markets have returned on a stable basis to economic fundamentals, it should not exercise its discretion to grant any hedge exemptions to hedge financial risk and it should phase out all existing exemptions of this nature. Again, as mentioned above, Congress has not mandated that those hedging financial risk be deemed "bona fide hedgers." By a 1987 *interpretation* only (and not even by a substantive rule), the Commission has afforded itself the *discretion* (not the *obligation*) to grant such exemptions. It must exercise that discretion with great prudence.

It should be noted that experience may very well demonstrate that the elimination of hedge exemptions to offset financial risk may, in and of itself, cure problems with the setting of position limits. For example, the PSI *Wheat Report* first recommended the abolition and phasing out of troublesome speculative hedge exemptions and then only, secondarily, suggested that consideration be given by the Commission to lowering the spot month limit for Chicago wheat from 6500 contracts to 5000 contracts where it had previously been.[73] This suggestion implicitly recognizes that the problem may not be with the setting of spot month position limits, but with the unwise granting of hedge exemptions for financial risk management from those limits.

The Methodology for Establishing CFTC Established Position Limits. In terms of the Commission methodology for establishing position limits, the first proposition must be that the Commission itself –not the Commission staff or the exchanges—should be the final decision maker about those limits. We understand that there may be a fine line between encouraging enough speculation to accommodate liquidity, but not allowing so much that speculation is excessive. However, the Commission has the experience of setting those limits for agricultural products. It has regulations that broadly govern and direct the methodology for position limit establishment.[74] We agree with those who have recommended that physical hedgers be very actively involved in that process. Indeed, we recommend that meetings equivalent to these very hearings be established to allow a broad array of participants to offer on a transparent basis technical guidance to the Commission about the establishment of these controls.

However, action of this nature must be done expeditiously with the recognition that the Commission has authority to fine tune limits it initially sets as experience dictates. The Commission may also want to prioritize its actions to address first those physical markets about which it has particular concern. It should also consider using emergency agency decision making authorities afforded by the Administrative Procedures Act or, where appropriate, the express emergency authority within § 8a (9) of the CEA to expedite its processes. The latter provision expressly authorizes on an immediate basis both the establishment of temporary emergency margining and/or position limits if the Commission finds that there is a "major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity."

The CFTC Should Press for Legislation to Set Aggregate Position Limits. Originally proposed by Chairman Joseph Lieberman and Ranking Member Susan Collins of the Senate Homeland Security and Government Affairs Committee, the Senate Democratic Leadership in the last Congress sponsored and brought to the Senate floor on July 25, 2008, S. 3268, which required that position limits be set in the aggregate upon traders in energy derivatives markets, rather than on an exchange-by-exchange basis. Fifty of 93 senators present at that time voted in favor of S. 3268, but the bill's supporters were not able to invoke cloture by gaining the support of the additional Senators necessary to close off debate.[75] As these hearings have suggested, there continues to be strong support for aggregate limits of this kind.

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[73] Wheat Report, *supra* note 16, at 13-14.
[74] 17 C.F.R. § 1.3(z) and Part 150.
[75] *See* S.3268, 110th Cong. (2008), *available at* http://ecip.loc.gov/cgi-bin/bdquery/z?d110:SN03268*:* (last visited Aug. 2, 2009).

Aggregate position limits mean that the corporate control entity under which physical futures trading is done would be assigned limits on futures trading for the entire entity for each physical derivatives market. Those limits could be expended by traders in the control entity in any manner which they see fit whether it be in regulated or unregulated futures exchanges; on the unregulated over-the-counter markets; or any combination among those markets. Once the trading entity's limits were hit, however, all traders within the entity would be barred from further trading in any of these derivatives venues. Under S. 3268, exemptions from aggregate limits were strictly tied to commercial (not financial) risk hedging.

By setting aggregate position limits on the trader's control entity wherever its affiliates trade, rather than establish limits within each exchange over which the CFTC has jurisdiction, the aggregate controls apply whether or not the trading venue is regulated. In other words, by applying overarching limits to the derivatives trader's control entity wherever trading is conducted, rather than establishing limits for trading on each regulated venue, the aggregate position limits make the regulatory nature of the trading venue irrelevant.

The question has been raised at these hearings whether aggregate position limits can be established by the Commission under existing law. While not a model of clarity, §4a(c) appears to be tied to trading done on markets over which the CFTC has jurisdiction. It may be that there could be aggregate position limits among those markets over which the CFTC now has jurisdiction; but not OTC markets. Accordingly, legislative authority should be sought as a high priority to allow the CFTC to utilize overarching limits across all markets by all trading done within a control entity whether the trading venue is directly regulated or not.

Of course, if, as is the recommendation of the Obama Administration, all standardized derivatives must ultimately be traded on an exchange[76], much of what is now the OTC physical derivative trading would be subject to CFTC oversight. Accordingly, even without further legislative authority, position limits could then be set for each exchange, and in setting those limits, the CFTC could accommodate and control trading patterns across all markets within each venue. Either individual exchange-based position limits could be established consistent with aggregate patterns of trading; or the CFTC might adopt aggregated limits for traders to use among all regulated markets.

If legislation is passed that requires mandatory clearing, rather than mandatory exchange trading, it should be clarified that CFTC position limits would apply to clearing facilities. Indeed, the recent articulation of "Principles for OTC Derivatives Legislation" announced on July 30, 2009 by House Chairmen Barney Frank and Collin Peterson of the Agriculture and Financial Services Committees, respectively, provide that the federal regulator "should have authority to

[76] Letter from Americans for Financial Reform, *supra* note 2, at 2.

prohibit or regulate transactions that are not traded on exchange or cleared."[77] This principle therefore includes the authority of the regulator to oversee transactions that are otherwise deemed subject to off exchange or off clearing trading. That power would certainly include the ability to develop aggregate position limits that cover *all* derivatives markets whether directly regulated or not.

The Commission Has Concluded That the CEA Does Not Authorize Agricultural Swaps in The Absence of A Transparent CFTC Section 4 (c) Exemption. As the PSI *Wheat Report* makes clear about 18% of the Goldman Sachs swaps-based Commodity Index is based on agricultural products. Moreover, the PSI *Wheat Report* notes that not only is trading in existing commodity index funds rising, but that certain traders had advised the subcommittee that "that the OTC market for agricultural swaps has recently begun expanding."[78]

However, the plain language of the CEA, even as amended by the highly deregulatory CFMA, does not permit an OTC agricultural market in the absence of an exemption from the Act's exchange trading. That exemption can only be granted by the CFTC exclusively under § 4(c) of the Act. Indeed, the CME has recognized this limitation by seeking a §4(c) exemption to market certain agricultural swaps; and the Commission, in granting that 4(c) exemption, expressly concluded: "A number of exemptions and exclusions for off-exchange derivatives transactions were subsequently added to the Act by the Commodity Futures Modernization Act of 2000, *but none apply to agricultural contracts*."[79]

In reaching the conclusion that agricultural swaps are not automatically excluded from the exchange trading requirement of the CEA, the Commission cited §§ 2 (d), (g) and (h) of the Act. Section 2 (g) of the Act, which expressly concerns swaps transactions excluded from the Act's exchange trading requirement, expressly states that that section shall apply to any contract "*other than an agricultural commodity*" (emphasis added). Section 2 (h), which concerns "exempt commodities," by that term's definition in § 1a(14) does not include "an . . . *agricultural* commodity." Section 2 (d) concerns "excluded derivative transactions," other than swaps. The definition of excluded derivatives transactions in § 1a (13) does not include commodities for which there is a "cash market," such as agricultural products.[80]

[77] "Description of Principles for OTC Derivative Legislation," *available at* http://www.securitiesindustry.com/news/-23750-1.html?source_dept=compliance_regulation (last visited Aug. 2, 2009).
[78] Wheat Report, *supra* note 16, at 104, n. 187.
[79] 74 Fed. Reg. 12316 (March 24 2009) (emphasis added and internal citations omitted.).
[80] *See*, *e.g.*, Written statement of Daniel J. Roth, President and Chief Executive Officer, National Futures Association, *Hearing before the Committee on Agriculture, U.S. House of Representatives* (Feb. 3, 2009) at 4 ("[Excluded commodities] are primarily financial commodities, indices, and contingencies."), *available at* http://agriculture.house.gov/testimony/111/h020309/Roth.doc (last visited Aug. 2, 2009); Glenn S. Arden, JONES DAY COMMENTARIES, *Commodity Futures Modernization Act of 2000* 3 ("excluded commodities . . . . encompass

Accordingly, swaps indexes or bi-lateral negotiated swaps that relate to agricultural products are, as the Commission concluded, unlawful *unless* the CFTC has authorized them under § 4(c) as being consistent with the purposes of the Act and the public interest. It is our understanding that none of the commodity indexes now marketed have such a § 4(c) exemption.

The CFTC Should Exercise Its Authority to Directly Regulate All Crude Oil Futures Trading on U.S. Terminals. Another of the issues which has arisen in this hearing is whether ICE Futures Europe, which trades on U.S.-based trading terminals a cash settled crude oil WTI futures contract linked to NYMEX WTI contracts, will be subject to new CFTC position limits and hedge exemption policies. NYMEX is a U.S. designated contract market directly regulated by the CFTC. Positions limits affecting NYMEX's traditional physical futures trading are squarely within the CFTC's jurisdiction. ICE Futures Europe, however, operates its WTI crude oil derivatives futures contract trading under a 1999 CFTC staff no action letter issued to a predecessor U.K. exchange, the International Petroleum Exchange, which places ICE Futures Europe's substantial U.S. terminal trading under the direct regulatory supervision of the U.K.'s Financial Services Authority.[81]

There has been substantial debate within Congress over ICE Futures Europe's regulatory status as a U.K. regulated company at the same time it offers U.S. citizens trading privileges on U.S. terminals in a futures contract denominated in U.S. dollars and premised on the U.S. benchmark WTI contract. No doubt in response to that Congressional concern, on June 17, 2008, the CFTC staff amended ICE Futures Europe's no action letter to add four new conditions to maintaining its status as a U.K. regulated entity, including a requirement that ICE Futures Europe adopt the position limits used by its principal U.S. competitor in energy futures trading, NYMEX.[82] Therefore, any CFTC mandated changes in WTI position limits applicable to NYMEX would also indirectly be applicable to ICE Futures Europe.

While the CFTC therefore has an indirect method for establishing its position limit and hedge exemption regime upon ICE Futures Europe, there continues to be considerable discussion about why the CFTC does not simply terminate ICE Futures Europe's no action letter (as that letter and amendments to it expressly allow),thereby bringing that exchange under CFTC day-to-day supervision for its U.S.-based trading. Subcommittee Chairman Stupak raised this point in this testimony in these hearings, and he led the legislative fight to include within the House-passed American Clean Energy and Security Act of 2009 a provision that would require ICE

most derivative financial products"), *available at* http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S1962 (last visited Aug. 2, 2009).

[81] International Petroleum Exchange of London Limited, CFTC No-Action Letter, CFTC Letter No. 99-69, *available at* http://www.cftc.gov/tm/letters/99letters/tm99-69.htm (last visited Aug. 2, 2009).

[82] International Petroleum Exchange (now ICE Futures Europe), CFTC No-Action Letter, CFTC Letter No. 08-09, *available at* http://www.cftc.gov/stellent/groups/public/@lrlettergeneral/documents/letter/08-09.pdf (last visited Aug. 2, 2009).

Futures Europe to be regulated directly by the CFTC with regard to WTI crude oil trading on its U.S. terminals.[83]

As hinted at in other testimony in these hearings, some hold the position that, because § 4 (a)'s registration requirements do not apply to any exchange "located outside the United States" and § 4 (b) does not allow CFTC rules to "govern in any way" foreign exchanges, ICE Futures Europe's trading of the U.S. benchmark WTI contract on U.S. trading terminals with U.S. servers in U.S. denominated dollars is outside the reach of the CFTC.

Even if this were a correct reading of § 4, the trading on ICE Futures Europe's U.S.-based terminals can not in any sense be deemed "foreign." In this regard, ICE Futures Europe is the wholly owned subsidiary of a U.S. holding company, the Intercontinental Exchange ("ICE"), which is a Delaware corporation located in Atlanta, Georgia. ICE operates exempt commercial markets and regulated contact markets in the U.S. ICE Futures Europe has trading terminals in the U.S.; its trading engines are in Chicago, Illinois; and it has traded a considerable portion of U.S. WTI crude oil futures market. Whatever protection section 4 has for exchanges "located outside the United States," ICE Futures Europe, insofar as it trades the U.S. benchmark crude oil futures contract in the United States with U.S. trading engines and terminals, is very much located here.

Moreover, the underlying premise of the no action letter on which ICE Futures Europe relies is that, but for the no action letter, that exchange would be fully subject to U.S. regulation when it brings its trading terminals physically into the U.S. That was true when the no action letters were first issued in 1999;[84] when the CFTC issued its 2006 Policy on this subject;[85] and it is evidenced by the CFTC staff's June 17, 2008 letter to ICE Futures Europe expressly stating that the failure to comply with the four new conditions, including position limits, imposed by the CFTC staff at that time would lead to a recommendation to "institute enforcement action against [ICE Futures Europe] based on a failure to seek contract market designation or registration as a DTEF under Sections 5 and 5a of the Act."[86]

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[83] H.R. 2454, 111th Cong. §351(2009).

[84] The no action letters at issue originated from a rulemaking proceeding, that by it very terms, provided that permission to put terminals in the U.S. derived from Section 4 (c)'s exemption from U.S. contract market registration requirements and not from a statutory prohibition from regulating foreign exchanges "outside of the United States." *See* LIFFE Administration & Management, CFTC No-Action Letter, 1999 CFTC Ltr. LEXIS 38, 3 n. 4 (July 23, 1999); Access to Automated Boards of Trade (proposed rules), 64 Fed. Reg. 14,159, 14,174 (Mar. 24, 1999).

[85] "In the absence of no-action relief, a board of trade, exchange or market that permits direct access by U.S. persons might be subject to Commission action for violation of, among other provisions section 4 (a) of the CEA, if it were not found to qualify for the exclusion from the DCM designation or DTEF registration requirement." 71 Fed. Reg. 64,443, 445 n.23 (Nov. 2, 2006).

[86] *See* June 17, 2008 CFTC Staff Letter, *supra* note 82.

The CFTC's stance in its June 17 letter to ICE Futures Europe is in keeping with a host of federal cases and CFTC enforcement actions making it clear that the prohibitions on the CFTC with regard to foreign exchanges within section 4 only applies when *foreigners* trade foreign futures contracts in *foreign* countries on *foreign* exchanges that do not significantly impact U.S. markets.[87]

As evidenced by the June 17, 2008 CFTC staff letter establishing further conditions on ICE Futures Europe's U.S. trading operations, it appears that the CFTC is trying hard to indirectly create *equivalency* between what is required of a U.S. exchange directly regulated by it and a direct competitor exchange, ICE Futures Europe, in the latter's present capacity as a U.K. regulated exchange for purposes of its substantial futures trading in the U.S.

In so doing, the CFTC is dependent on data flowing smoothly from the U.K's market regulator, the Financial Services Authority ("FSA"), and the CFTC. Media reports have suggested that in important instances data of this nature has not always flowed as effectively as the CFTC would have hoped. Nevertheless, under the present dependency of the CFTC on the U.K.'s FSA, for trading done by ICE Futures Europe in the U.S., and despite the CFTC's hard work in gaining equivalency with regard to direct competition in the U.S. between U.S. DCMs and ICE Futures Europe, important regulatory measures applicable in the U.S. still do not apply to ICE Futures Europe. For example, the self regulation required of U.S. DCMs (so that they are the CFTC's frontline against market abuses) *in practice* is much more demanding here than what is required in the U.K. Also, § 8a (9)'s important grant of emergency powers to the CFTC to take strong, direct and immediate action in markets under its jurisdiction does not apply to those exchanges falling under the FSA's authority. As a matter of prudence, the CFTC should assume direct supervision of substantial futures trading done in the U.S. by U.S. citizens on important U.S. benchmark crude oil futures contracts which is in direct competition in the U.S. with a U.S. regulated exchange.

[87] See the discussion of relevant cases in Written Testimony of Professor Michael Greenberger, *Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation? – Part II: Hearing Before the House Energy and Commerce Subcomm. on Oversight and Investigations* 9-12 (June 23, 2008), *available at* http://www.michaelgreenberger.com/files/June_23_2008_testimony.pdf (last visited Aug. 2, 2009).

Americans for Financial Reform

Executive Committee

Heather Booth – Americans for Financial Reform
Stephen Abrecht – Service Employees International Union
Gary Kalman – U.S. PIRG
Nancy Zirkin/Lisa Rice – Leadership Conference on Civil Rights/National Fair Housing Alliance
Rob Johnson – Roosevelt Institute
James Carr – National Community Reinvestment Coalition

Steering Committee

Maureen Thompson – The Hastings Group
Bob Borosage – Campaign for America's Future
Stephen Abrecht – Service Employees International Union
David Arkush – Public Citizen
Heather Booth – Americans for Financial Reform
Janis Bowdler – National Council of La Raza
James Carr – National Community Reinvestment Coalition
Alan Charney – USAction
Nita Chaudhary – MoveOn.org Political Action
Richard Ferlauto – American Federation of State, County and Municipal Employees
George Goehl – National People's Action/National Training and Information Center
Rob Johnson – Roosevelt Institute
Gary Kalman – U.S. PIRG
Robert Kuttner – Demos
Daniel Pedrotty – AFL-CIO
Travis Plunkett – Consumer Federation of America
Lisa Rice – National Fair Housing Alliance
Jennifer Vasiloff – Opportunity Finance Network
Ryan Wilson – AARP
Nancy Zirkin – Leadership Conference on Civil Rights