AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

HEARING TO REVIEW THE SOURCE OF DRAMATIC MOVEMENTS IN THE COMMODITY MARKETS (AGRICULTURE AND ENERGY): A CHANGE IN MARKET FUNDAMENTALS OR INFLUENCE OF INSTITUTIONAL INVESTORS?

HEARING

BEFORE THE

SUBCOMMITTEE ON
GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

OF THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

MAY 15, 2008

Serial No. 110–37

Printed for the use of the Committee on Agriculture
agriculture.house.gov

U.S. GOVERNMENT PRINTING OFFICE

42–967 PDF WASHINGTON : 2008

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON AGRICULTURE

COLLIN C. PETERSON, Minnesota, *Chairman*

TIM HOLDEN, Pennsylvania, *Vice Chairman*
MIKE McINTYRE, North Carolina
BOB ETHERIDGE, North Carolina
LEONARD L. BOSWELL, Iowa
JOE BACA, California
DENNIS A. CARDOZA, California
DAVID SCOTT, Georgia
JIM MARSHALL, Georgia
STEPHANIE HERSETH SANDLIN, South Dakota
HENRY CUELLAR, Texas
JIM COSTA, California
JOHN T. SALAZAR, Colorado
BRAD ELLSWORTH, Indiana
NANCY E. BOYDA, Kansas
ZACHARY T. SPACE, Ohio
TIMOTHY J. WALZ, Minnesota
KIRSTEN E. GILLIBRAND, New York
STEVE KAGEN, Wisconsin
EARL POMEROY, North Dakota
LINCOLN DAVIS, Tennessee
JOHN BARROW, Georgia
NICK LAMPSON, Texas
JOE DONNELLY, Indiana
TIM MAHONEY, Florida

BOB GOODLATTE, Virginia, *Ranking Minority Member*
TERRY EVERETT, Alabama
FRANK D. LUCAS, Oklahoma
JERRY MORAN, Kansas
ROBIN HAYES, North Carolina
TIMOTHY V. JOHNSON, Illinois
SAM GRAVES, Missouri
MIKE ROGERS, Alabama
STEVE KING, Iowa
MARILYN N. MUSGRAVE, Colorado
RANDY NEUGEBAUER, Texas
CHARLES W. BOUSTANY, JR., Louisiana
JOHN R. "RANDY" KUHL, JR., New York
VIRGINIA FOXX, North Carolina
K. MICHAEL CONAWAY, Texas
JEFF FORTENBERRY, Nebraska
JEAN SCHMIDT, Ohio
ADRIAN SMITH, Nebraska
TIM WALBERG, Michigan
BOB LATTA, Ohio

PROFESSIONAL STAFF

ROBERT L. LAREW, *Chief of Staff*
ANDREW W. BAKER, *Chief Counsel*
APRIL SLAYTON, *Communications Director*
WILLIAM E. O'CONNER, JR., *Minority Staff Director*

SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT

BOB ETHERIDGE, North Carolina, *Chairman*

DAVID SCOTT, Georgia
JIM MARSHALL, Georgia
JOHN T. SALAZAR, Colorado
NANCY E. BOYDA, Kansas
STEPHANIE HERSETH SANDLIN, South Dakota
BRAD ELLSWORTH, Indiana
ZACHARY T. SPACE, Ohio
TIMOTHY J. WALZ, Minnesota
EARL POMEROY, North Dakota

JERRY MORAN, Kansas, *Ranking Minority Member*
TIMOTHY V. JOHNSON, Illinois
SAM GRAVES, Missouri
CHARLES W. BOUSTANY, JR., Louisiana
K. MICHAEL CONAWAY, Texas
FRANK D. LUCAS, Oklahoma
RANDY NEUGEBAUER, Texas
BOB LATTA, Ohio

CLARK OGILVIE, *Subcommittee Staff Director*

CONTENTS

	Page
Etheridge, Hon. Bob, a Representative in Congress from North Carolina, opening statement	1
Moran, Hon. Jerry, a Representative in Congress from Kansas, opening statement	2
Peterson, Hon. Collin C., a Representative in Congress from Minnesota, prepared statement	3

WITNESSES

Harris, Jeffrey, Chief Economist, Commodity Futures Trading Commission, Washington, D.C.; accompanied by John Fenton, Director of Market Surveillance, Commodity Futures Trading Commission	4
Prepared statement	7
Stallman, Bob, President, American Farm Bureau Federation; Rice and Cattle Producer, Columbus, TX	42
Prepared statement	44
Duffy, Terrence A., Executive Chairman, Chicago Mercantile Exchange Group, Inc., Chicago, IL	49
Prepared statement	52
Ramm, Gerry, President, Inland Oil Company, Ephrata, WA; on behalf of Petroleum Marketers Association of America	61
Prepared statement	63
Newsome, Ph.D., James E., President and CEO, New York Mercantile Exchange, Inc., New York, NY	69
Prepared statement	72
Campbell, Laura, Assistant Manager of Energy Resources, Memphis Light, Gas & Water, Memphis, TN; on behalf of American Public Gas Association	88
Prepared statement	90
Niemeyer, Garry, Corn and Soybean Producer, Auburn, IL; on behalf of National Corn Growers Association	113
Prepared statement	115
Carlson, Layne G., Corporate Secretary and Treasurer, Minneapolis Grain Exchange, Minneapolis, MN	123
Prepared statement	125
Clark, Rodney, Vice President, CGB/Diversified Services; Chairman, Risk Management Committee, National Grain and Feed Association, Mt. Vernon, IN	129
Prepared statement	131
Farley, Thomas, President and COO, ICE Futures U.S., New York, NY	138
Prepared statement	140
Weil III, Adolph "Andy," President, American Cotton Shippers Association; Member, Executive Committee, National Cotton Council, Montgomery, AL	144
Prepared statement	147

SUBMITTED MATERIAL

Eastland, Woods, President and CEO, Staplcotn, Greenwood, MI; on behalf of Amcot, submitted statement	169
Farley, Thomas, President and COO, ICE Futures U.S., New York, NY, response to submitted questions	203
Lukken, Hon. Walter, Acting Chairman, Commodity Futures Trading Commission, Washington, D.C., response to submitted questions	190
National Cotton Council, submitted statement	167
Paul, Eugene, Policy Analyst, National Farmers Organization, Ames, IA, submitted statement	186

HEARING TO REVIEW THE SOURCE OF DRAMATIC MOVEMENTS IN COMMODITY MARKETS (AGRICULTURE AND ENERGY): A CHANGE IN MARKET FUNDAMENTALS OR INFLUENCE OF INSTITUTIONAL INVESTORS?

THURSDAY, MAY 15, 2008

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND
RISK MANAGEMENT,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Subcommittee met, pursuant to call, at 10:03 a.m., in Room 1300 of the Longworth House Office Building, Hon. Bob Etheridge [Chairman of the Subcommittee] presiding.

Members present: Representatives Etheridge, Scott, Marshall, Salazar, Boyda, Herseth Sandlin, Ellsworth, Pomeroy, Moran, Boustany, Conaway, Lucas, Neugebauer, and Latta.

Staff present: Andy Baker, Adam Durand, Alejandra Gonzalez-Arias, Scott Kuschmider, Merrick Munday, Clark Ogilvie, John Riley, Bryan Dierlam, Kevin Kramp, and Jamie Weyer.

OPENING STATEMENT OF HON. BOB ETHERIDGE, A REPRESENTATIVE IN CONGRESS FROM NORTH CAROLINA

The CHAIRMAN. This hearing of the Subcommittee on General Farm Commodities and Risk Management to review the source of dramatic movement in commodity markets (agriculture and energy): a change in market fundamentals or influence of institutional investors, will come to order. Let me thank all of you for being here. Let me thank the witnesses for coming today. We have a pretty full calendar, and we will try to accommodate everyone. You know the order in this Committee. Normally Members will be coming back and forth, but I can assure you the Chairman and Ranking Member are going to be here the whole time except when we have to go vote. We will put a chain on his legs, so both of us will be here.

Let me thank each one of you for coming today. And as all of you know, the Agriculture Committee has been a little busy the last several months working on a small piece of legislation. It is normally called the farm bill. This year it is called the Nutrition and Energy Title, and the House passed it yesterday. Now that we have finished the work on this piece of legislation, I think it is appropriate that we turn our attention to other issues affecting American agriculture. Today's hearing is on a subject for which I have

been hearing a great deal of consternation, not only from farmers but from a lot of average people in my district, and really across the country.

And here are a few facts over the past year on futures process of how they have increased: 47 percent for cotton, 66 percent for corn, 83 percent for soybeans, 95 percent for wheat, and 122 percent for rice. Normally you would find that farmers would be dancing in the fields, wherever they find a place to dance, to see price increases of this magnitude. But these higher prices have come with increased volatility in commodity trading and with consequences. The financial demands associated with using the futures market, particularly rising margin requirements, have made it difficult for market participants to continue using futures for price discovery and price hedging and forced some out of the market entirely. This in turn has led commodity buyers to refrain from offering contracts to producers, one of the key risk management practices that farmers have utilized for a long time.

While agriculture commodity markets are not used to these levels of prices, or the largest swings in prices that we have been seeing recently, other commodity markets, particularly oil and natural gas, have been experiencing these conditions for some time. Gold futures are 37 percent higher from the past year, and crude oil futures have increased almost 82 percent in the last year. This Subcommittee has specifically looked at these energy markets last year and in previous Congresses. As you know, the farm bill includes additional authority for the Commodity Futures Trading Commission to police contracts of some of the more lightly regulated markets.

Support for this additional authority came out of our hearing on energy trading. Last month, the CFTC held a hearing to look into whether futures markets are properly performing their risk management and price discovery roles for agriculture. With this hearing, we are building upon that work and expanding it to include energy because not only does energy trading affect industrial users of energy products and consumers, it affects agriculture producers as well. While everyone agrees on the facts, there is no consensus on the theory behind the recent run up in commodity prices or increased volatility. The CFTC hearing covered a wide range of viewpoints as to factors behind these market changes.

Understandably, not all of those reports agree nor was a consensus reached, but I don't think we will definitively answer that question today. It is important for Members to hear the arguments and the debate. Again, I want to thank the witnesses for participating. Now I will turn to my partner and the gentleman from Kansas, Mr. Moran, for his opening statement.

OPENING STATEMENT OF HON. JERRY MORAN, A REPRESENTATIVE IN CONGRESS FROM KANSAS

Mr. MORAN. Mr. Chairman, thank you very much. I am happy to be here with you and serve as your partner as we explore a very important topic that farmers across the country care about. Today's agriculture is experiencing some of the most favorable market conditions in nearly a decade. In the last year, agriculture commodity markets, we have seen a tremendous appreciation price, and for

the most part farmers welcome this news. With increased prices, however, as you say, come new challenges. As prices increase, the ability to utilize futures market as risk management tools become more challenging, as prices fluctuate and capital requirements increase to maintain market positions.

While commodity prices have increased, the volume of trading and the number of participants in the commodity markets have also experienced record growth. The growth in the commodity markets is by no means a negative development. Increased market participation leads to additional equity and more opportunities for commercial market participants to utilize futures markets. The role of this Subcommittee is to insure that the Commodity Futures Trading Commission is doing its job to ensure that markets are functioning and that price discovery is occurring in an efficient manner.

Today we will hear from a variety of witnesses that include the CFTC, futures exchanges, and market participants. I hope this Subcommittee can learn about the new challenges that market participants are experiencing. In addition, I look forward to seeing the data and market conditions that CFTC is monitoring, and if necessary determine whether there is something that can be done to better ensure that the markets are functioning properly. One thing I think we should not do is simply out of hand conclude that certain classes of market participants are to blame for the challenges we are experiencing in the prevailing market. Increased market participation can be a good thing, and additional participants can provide the equity necessary for more efficient conduct of price discovery.

For every commercial market participant, there is another noncommercial participant that offsets the commercial traders position. The job of this Subcommittee today is to listen to the findings of the agency that we have tasked with market surveillance. I hope the CFTC experts will provide an explanation of market data that they are currently monitoring whether the data demonstrates the existence of issues that need to be addressed and whether additional data is needed to draw more sound conclusions. They will tell us if there are ways that regulatory structure can be adjusted to assure market access for willing participants without unnecessarily disrupting the function of the markets. I thank you for holding this hearing. I am glad to be back in 1300 and at work on behalf of farmers of America. I thank the Chairman.

The CHAIRMAN. I thank the gentleman. The chair would request that other Members submit their opening statements for the record so that witnesses may begin their testimony and ensure that we have ample time for questioning.

[The prepared statement of Mr. Peterson follows:]

PREPARED STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Thank you, Mr. Etheridge, for holding this hearing this morning. We've all had a busy last few weeks, to say the very least, but I'm glad we are here today to discuss what has been happening in the agricultural and energy markets over the last several months.

I think anyone who has any sort of historical perspective following these markets had a hard time believing the kind of prices we have seen in recent months.

I don't know too many people, for example, who ever envisioned $12 wheat futures, much less $24 wheat futures, like we saw on the March 2008 Minneapolis contract.

And prices are not just trending upward, they are moving rapidly in shorter periods of time. Daily trading limits on exchanges have been triggered on a regular basis, sometimes on consecutive days for the same contract. These wild swings call into question the role of futures markets as mechanisms for price discovery and risk management that work to benefit producers, processors and consumers.

Furthermore, in many cases, farmers are not the ones seeing the benefits of these high prices.

Farmers have been unable to enter into forward contracts with grain elevators because elevators have run up against their credit limits due to rapid price swings in a short amount of time. Some elevators have had to triple, quadruple, even go up to eight times their normal credit line just to finance margin calls on their positions. These are not speculators. These are people involved in production agriculture who depend on the markets for stability and solvency.

Many of these issues were brought up last month when the Commodity Futures Trading Commission hosted an all-day hearing on commodity prices and the rise of large speculative positions. CFTC took testimony from more than 30 participants, some of whom are here before this Committee today.

A lot of opinions were offered and a lot of ideas were exchanged at that hearing. Unfortunately, I heard a lot of disappointment expressed from many sectors of agriculture coming out of that hearing about CFTC's apparent lack of interest in acting on the increasing lack of convergence in cash and futures prices.

In my opinion, there are some real problems in the run-up we are seeing in these prices. I believe commodity contracts have become more popular as investment vehicles instead of the price discovery function for which the contracts were created. And this group of traders is growing larger and more influential given the size of some of their positions.

A commodity futures market needs to have some semblance of stability to have any value to its participants. The issue of traders and hedgers getting caught up in the flood of speculators and hedge funds is of concern to this Committee and I think in time it will require some form of action. I look forward to hearing from today's witnesses for their perspective and I welcome back my time.

The CHAIRMAN. We would like to welcome our first panel to the table, Mr. Jeff Harris, Chief Economist, Commodity Futures Trading Commission, Washington, D.C. He is accompanied by Mr. John Fenton, Deputy Director, Market Surveillance Section, Commodity Futures Trading Commission, Washington, D.C. Mr. Harris, please begin when you are ready, and I would ask that you summarize your statement in 5 minutes, and your full statement without objection will be entered into the record.

STATEMENT OF JEFFREY HARRIS, CHIEF ECONOMIST, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.; ACCOMPANIED BY JOHN FENTON, DIRECTOR OF MARKET SURVEILLANCE, COMMODITY FUTURES TRADING COMMISSION

Mr. HARRIS. Thank you, Mr. Chairman, and Members of the Committee. I am Jeffrey Harris, Chief Economist of the Commodity Futures Trading Commission, testifying along with my colleague, John Fenton, who is our Director of Market Surveillance. We appreciate the opportunity to discuss the CFTC's role with respect to futures trading and our current view of market trends that the government is charged with overseeing. These are extraordinary times in our markets. Many commodity futures prices have hit unprecedented levels. In the last 3 months, the agricultural staples of wheat, corn, soybeans, rice and oats have hit all-time highs, as you can see from our *Chart 1* here.

We are also witnessing record prices in crude oil and natural gas, and other energy-related products. Adding to these trends, the

emergence of the subprime crisis last summer and weak returns in equity and debt markets have led investors to increasingly seek portfolio exposure in commodities as an asset class. We are continually doing new analysis on our detailed market data, applying new research methods, building bridges to outside researchers and government agencies all to increase our view of futures markets. And separately our Division of Enforcement investigates any specific information of potentially manipulative conduct on a case-by-case basis.

In line with these efforts, the agency convened an agriculture forum 3 weeks ago, in which we brought together a diverse group of market participants to air full views and opinions on the driving forces in these markets. The agency allowed a 2 week comment period following the hearing which just closed last Wednesday. Currently the Commission and staff are reviewing the comments received, and the Commission plans to have announcements of several initiatives in the very near future. The CFTC also recently announced the creation of the Energy Markets Advisory Committee and named the public members of the committee. That first meeting will be held on June 10 to look at issues related to energy markets and the CFTC's role in those markets under the Commodity Exchange Act.

Clearly, the commodity futures markets are experiencing robust growth across commodities particularly with the recent influx of institutional investors. There are two basic types of institutional activities that tend to be referred to as funds in our markets. Each is identified to some degree of accuracy within our large trader reporting system. The first group of funds represents monies that enter into futures markets through various form of managed money like hedge funds, commodity pools, and the like. Managed money funds can either be long or short in our markets depending on their speculative beliefs about future prices. The second type of fund, known as index funds, or commodity index traders, have become more important in recent years. These funds seek commodity exposure as an asset class like stocks, bonds, or real estate, and aggregated, index fund positions are relatively large. They are predominantly long and passively positioned, that is, they simply buy exposure to commodities in futures markets, maintain their exposure through pre-specified rolling strategies before the futures enter delivery months.

It is equivalent to a "buy and hold" strategy in the stock market. In response to the growing activity by commodity index traders, in fact, the Commission has increased transparency in 12 agricultural markets by publishing weekly data on positions held by these index traders since January of 2007. Some observers have suggested that higher crude oil futures prices and agricultural commodity futures prices are being driven by speculators in the futures markets and have suggested steps to reduce or limit their actions in these markets. The CFTC has been actively engaged with the industry participants during this time of extraordinary price increases, and the data demonstrates the influence of fundamental factors in commodity prices.

First, we note that prices have risen sharply for many commodities that have neither developed futures markets like durum

wheat and steel, nor institutional fund investments like the Minneapolis wheat contract and Chicago rice. Second, in some markets where index trading is greatest as a percentage of open interest, such as the live cattle and hog futures markets, they have actually suffered from falling prices during the past year. Beyond these fundamentals, we have utilized our comprehensive data to rigorously analyze the role of hedgers and speculators to both energy and agricultural futures markets. All the data modeling and testing and analysis that we have done to date indicates there is little economic evidence to demonstrate that futures prices are systematically driven by speculators in these markets.

The next chart highlights data on speculative positions. Here we highlight managed money trader positions in crude oil, for example. Generally, this chart shows that during the past year as crude oil futures prices have increased as denoted by the black line there the level of speculative positions have remained relatively constant in percentage terms. As the chart shows, managed money traders are both long, represented by the green bars, and short, represented by the orange bars, in these markets. Although not depicted directly in this picture, our studies in agriculture and crude oil markets have found that speculators tend to be trend followers in these markets, that is, speculators generally tend to buy the day after prices increase.

Simply put, the economic data shows that the overall commodity price levels including agriculture commodities and energy futures prices are being driven by powerful economic forces and the laws of supply and demand. These fundamental economic factors include increased demand from emerging markets, decreased supply through weather or geopolitical events and the weakened dollar. Together these fundamental economic factors have formed the perfect storm that is causing significant upward price pressure on futures prices across the board. Given the widespread impact of the higher futures prices, the CFTC will continue to collect and analyze data closely. The agency prides itself on a robust surveillance and enforcement program complemented by rigorous economic analysis that we use to oversee U.S. futures and options markets.

At the Commission, we are devoting and we will continue to devote an extraordinary amount of resources to ensure that futures markets are responding to fundamentals and are serving the role of hedging and price discovery. Thank you for the opportunity testify today, and we look forward to answering your questions.

[The prepared statement of Mr. Harris follows:]

Commodity Futures Trading Commission
Office of External Affairs
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
202.418.5080

Testimony

Written Testimony of Jeffrey Harris, Chief Economist and John Fenton, Director of Market Surveillance Before the Subcommittee on General Farm Commodities and Risk Management, Committee on Agriculture

United States House of Representatives

May 15, 2008

Thank you, Mr. Chairman and members of the Committee. I am Jeffrey Harris, Chief Economist of the Commodity Futures Trading Commission (CFTC or Commission), testifying along with my colleague John Fenton, Director of Market Surveillance. We appreciate the opportunity to discuss the CFTC's role with respect to the agriculture commodities markets and our view of current trends in the markets as the government regulator charged with overseeing them.

CFTC Mission

Congress created the CFTC in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the United States. Broadly stated, the CFTC's mission is two-fold: to protect the public and market users from manipulation, fraud, and abusive practices; and to ensure open, competitive and financially sound markets for commodity futures and options.

These markets play a critical role in the U.S. economy by providing risk management tools that producers, distributors, and commercial users of commodities use to protect themselves from unpredictable price changes. The futures markets are also designed to discover prices that accurately reflect information on supply, demand, and other factors.

Overview of Current Trends in the Futures Markets

These are extraordinary times for our markets: many commodity futures prices have hit unprecedented levels. In the last three months, the agricultural staples of wheat, corn, soybeans, rice and oats have hit all-time highs – as you can see in Chart 1.

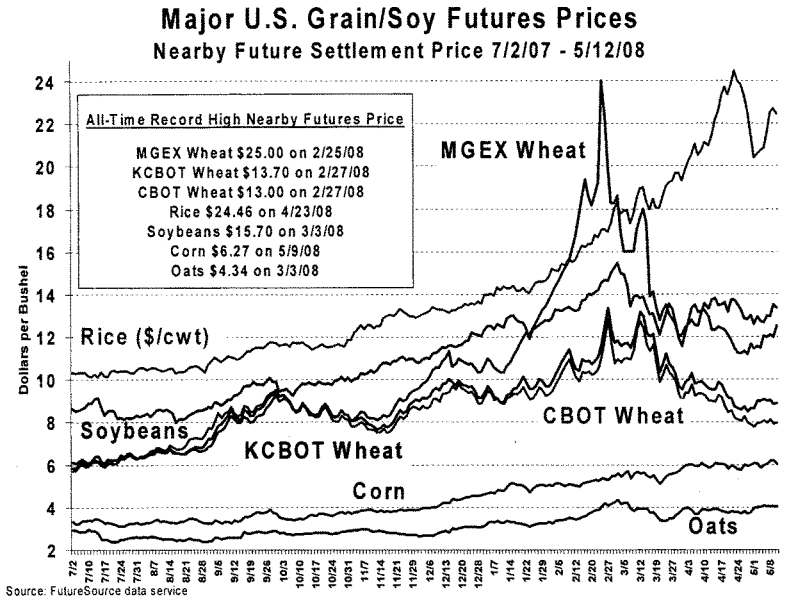


Chart 1: Major U.S. Grain and Soy Futures Prices

We are also witnessing record prices in crude oil, gasoline and other related energy products. Both macro- and micro-economic factors are at work in these prices. Broadly speaking, the weak dollar, strong demand from the emerging world economies, geopolitical tensions in oil-producing regions, supply disruptions, unfavorable weather, and increased production of ethanol have contributed to driving up many commodity futures prices.

Adding to these trends, the emergence of the sub-prime crisis last summer and weak returns in equity and debt markets have led investors increasingly to seek portfolio exposure in commodities as an asset class. As the federal regulator of the futures markets, the CFTC is working to ensure that they are working properly for producers, dealers, processors, consumers and investors. To date, CFTC staff economic analysis indicates that broad-based manipulative forces are not driving the recent higher futures prices in commodities across-the-board. That said, we continue to gather information from the entire marketplace and welcome outside analysis and perspectives so that we can ensure that our view of these markets is complete and accurate. We are continually doing new analysis of our detailed market data, applying new research methods, and building bridges with outside researchers and government experts all to increase our understanding of the futures markets. And separately, our Division of Enforcement investigates any specific instances of potentially manipulative conduct on a case-by-case basis.

In line with these efforts, the agency convened an agriculture forum three weeks ago in which we brought together a diverse group of market participants for a full airing of views and opinions on the driving forces in these markets. For those unable to attend, the agency allowed a two week period after the forum for public comment, which closed last Wednesday. Currently, the Commissioners and staff are reviewing the comments we received, and the Commission plans to announce several initiatives in the near future. We are working closely with market participants to address concerns aired around this forum to ensure the markets are functioning properly.

The CFTC also recently announced the creation of an Energy Markets Advisory Committee and named the public members of the Committee two weeks ago. Our first meeting of that group is scheduled for June 10th to look at issues related to the energy markets and the CFTC's role in these markets under the Commodity Exchange Act (CEA). These public forums will enhance our ability to make informed decisions as we strive to improve our oversight of these important markets.

Using Data to Oversee the Markets and to Enforce the CEA

The CFTC receives a tremendous amount of data every day about market fundamentals, futures trading activity, and, most importantly, confidential data about traders participating in the markets. The agency's Large-Trader Reporting System is the cornerstone of our surveillance system. Under that system, clearing members, futures commission merchants (FCMs), foreign brokers, and individual traders file confidential reports with the CFTC each day, reporting positions and identifying each large trader in each designated contract market (DCM). For example, in the NYMEX WTI crude oil futures contract a trader with a position exceeding 350 contracts in any single expiration is "reportable." Large-trader positions reported to the CFTC consistently represent more than 90% of total open interest in the NYMEX WTI contract, with the remaining traders carrying smaller positions.

When a reportable trader is identified to the CFTC, the trader is classified either as a "commercial" or "non-commercial" trader. A trader's reported futures position is determined to be commercial if the trader uses futures contracts for the purposes of hedging as defined by CFTC regulations. Specifically, a reportable trader gets classified as commercial by filing a statement with the CFTC (using the CFTC Form 40) that it is commercially "...engaged in business activities hedged by the use of the futures and option markets." However, to ensure that traders are classified consistently and with utmost accuracy, CFTC market surveillance staff reviews the forms and re-classifies the trader if it has further information about the trader's involvement with the markets.

In addition to the breakdown between commercial and non-commercial traders, the large-trader data can be filtered by type of trading activity. For example, on the commercial side, the CFTC can sort the data by more than 20 types of trading entities, ranging from agricultural merchants and livestock feeders to mortgage originators. Traders that are non-commercial include hedge funds, commodity trading advisors, commodity pool operators (managed money traders), and floor brokers and traders.

Using data from the Large Trader Reporting System, the CFTC publishes a weekly breakdown of reportable positions of each Tuesday's open interest. This well-known

public report is called the Commitments of Traders (COT) report. COT reports are published each Friday afternoon for markets in which 20 or more traders hold positions above CFTC-established reporting levels. For reportable positions, the report shows commercial and non-commercial holdings, changes from the previous report, percentage of open interest by category, the concentration of positions held by the largest four and eight traders, and the numbers of traders in each category.

To complement the extensive surveillance program, the CFTC's strong enforcement program has been working hard to punish wrongdoers and to keep manipulators out of the markets. During the last five years, Enforcement has maintained a record level of investigations and prosecutions in nearly all market areas, including attempted manipulation, manipulation, squeezes and corners, false reporting, hedge fund fraud, off-exchange foreign currency fraud, brokerage compliance and supervisory violations, wash trading, trade practice misconduct, and registration issues. Enforcement also routinely assists in related criminal prosecutions by domestic and international law enforcement bodies. Through those efforts, during the past five years (April 2003 – March 2008), the CFTC has assessed more than $2 billion dollars in monetary sanctions, which include civil monetary penalties and orders to pay restitution and disgorgement.

Speculation in the Commodities Markets

The current market environment raises questions about the role that speculators play in affecting prices in the futures markets. The proper and efficient functioning of the futures markets requires both speculators and hedgers. Overly restrictive limitations on the number of speculative positions held by individuals or entities could impair liquidity. A less liquid market generally drives hedgers out by making hedging more costly and less effective. In the absence of reasonable hedging opportunities, commercial businesses may be forced to increase prices to compensate for unhedged risk. Diminished hedging activity can also impair price discovery in futures markets since commercial hedgers typically are a primary source for new market information. Diminishing the ability of futures markets to serve their hedging and price discovery functions would likely have negative consequences for commerce in commodities and ultimately, for the nation's economy.

Of course, excessive speculation can be detrimental to the markets. Under Section 4a of the CEA, the concept of "excessive speculation" is based on trading that results in "sudden or unreasonable fluctuations or unwarranted changes in the price" of commodities underlying futures transactions. The CEA does not make excessive speculation a *per se* violation of the Act, but rather, requires the Commission to enact regulations to address such trading (for example, through speculative position limits).

The Commission has utilized its authority to set limits on the amount of speculative trading that may occur or speculative positions that may be held in contracts for future delivery in agricultural markets. The speculative position limit is the maximum position, either net long or net short, in one commodity future (or option), or in all futures (or options) of one commodity combined, that may be held or controlled by one person (other than a person eligible for a hedge exemption) as prescribed by a DCM and/or by the Commission.

All agricultural and natural resource futures and options contracts are subject to either Commission or exchange spot-month speculative position limits. With respect to trading outside the spot month, the Commission typically does not require speculative position limits. Under the Commission's guidance, a DCM (which is a regulated futures exchange) may replace position limits with position accountability for contracts on financial instruments, intangible commodities, or certain tangible commodities. If a market has accountability rules, a trader – whether speculating or hedging – is not subject to a specific limit. Once a trader reaches a preset accountability level, however, the trader must provide information about the position upon request by the exchange. In addition, position accountability rules provide an exchange with authority to restrict a trader from increasing his or her position.

Finally, to achieve the purposes of the speculative position limits, the Commission and the exchanges will combine multiple positions in a contract when they are commonly owned or controlled by a single trader. These provisions apply to accounts having a 10 percent or greater financial interest by a single entity.

Violators of speculative limits are subject to disciplinary action. The Commission, or an exchange, may institute these actions depending on the circumstances.

Impact of Institutional Investors

Clearly, the commodity futures markets are experiencing robust growth across commodities, particularly with the recent influx of institutional investors. There is no question that investors and consumers are diversifying their portfolios and seeking exposure to the commodity markets. At the CFTC's recent agricultural forum, managers of pension fund money testified about their increased participation in commodity markets, explaining that commodity exposure substantially reduces portfolio risk when combined with equity and/or debt investments. At the forum, Doug Hepworth of Gresham Investment Management LLC described the benefit as follows: Starting with a portfolio consisting of 40% debt and 60% equities, a five percent commodity exposure was added. The performance of that portfolio was tracked for 196 rolling five-year periods beginning in 1987. On average, portfolio volatility was reduced by 10% by diversifying into commodities.

The arrival of these newer participants has, in some instances, coincided with observed price increases. Perhaps naturally, some have concluded that a portion of the high prices in agricultural and energy futures markets is related to the impact of financial trading in futures markets. Because these allegations come, in many cases, from experienced participants we do take them seriously and are examining this issue very carefully.

There are two basic types of trading activity that tend to be referred to as "funds." Each is identified to some degree of accuracy in our Large Trader Reporting System. The first represents traditional speculative monies that enter the futures markets through various forms of managed money (hedge funds, commodity pools, etc.). Managed money funds can be either long or short in our markets, depending on their speculative beliefs about future prices. The second type—referred to as "index funds or commodity index traders"—has become important in recent years. These funds seek commodities exposure as another asset class (like stocks, bonds, real estate, etc.). Aggregated,

index fund positions are relatively large, predominantly long, and passively positioned—that is, they simply buy exposure to commodities in futures markets and maintain their exposure through pre-specified rolling strategies (before the futures enter delivery months). It is the equivalent to the "buy and hold" strategy common in the stock markets. It is important to understand that dollars placed with index funds are not leveraged. An investor wanting a $10,000 exposure places that amount with the fund which is invested in futures contracts so as to replicate the dollar return of $10,000 invested in the indexed commodities. In response to the growing activity by commodity index traders, the Commission has increased transparency in twelve agricultural markets by publishing weekly data on positions held by index traders since January 2007.

Some in the industry believe the combined positions of "funds" are too large, and therefore must be causing or abetting high and/or volatile prices. COT data used by Commission staff show that price changes are largely unrelated to fund trading. In fact, record agriculture prices have occurred in commodities for which there is no futures contract (durum wheat and hay, for example) and in markets with little or no index trading. Specifically, Minneapolis wheat futures (not part of any index fund) have risen higher than and have been more volatile than Chicago or Kansas City wheat futures and Chicago rice (with relatively modest levels of index trading) has recently set new, all-time high prices.

Utilizing the detailed trader categories in the Large Trader Reporting System, the Office of the Chief Economist (OCE) has been examining daily position changes and price changes to determine whether a cause-effect link can be established between high prices and the trading of various categories of traders—including these funds independently and concurrently. This more general evidence shows that fund positions have not changed in ways that are consistent with causing recent agriculture price increases. CFTC staff has tracked daily price changes and daily position changes in these markets, finding that managed money funds are largely trend followers, buying on the day after price increases, for instance. Increased index fund positions do not lead to price increases either. For example, in the wheat market the data shows that funds were not adding to their positions during the run up in cash and futures prices. In fact, managed money funds were actually decreasing net long futures positions during the recent run up in wheat prices. The absence of a link between fund positions and price changes suggests that global market fundamentals, including restrictions on exports by several major exporters, provide a better explanation for recent price increases. Even with these facts, it is clear that more analysis and research about index trading needs to occur in order to inform this debate and CFTC staff will be studying ways to improve the transparency and efficiency of the markets regarding these types of traders.

In the agriculture commodities, wide basis relationships (cash-futures differentials), where they exist, are largely explained by historically high diesel prices. Since virtually all major modes of grain transportation (truck, rail, and barge) rely on diesel fuel, historically strong bids for grain at the major export facilities get proportionally lower as the grain is located further from those points and incurs higher transportation costs. For example, export terminal cash prices at New Orleans are very strong, but prices up-river along the Mississippi and Illinois are often much weaker due to the cost of barge freight, which is more than twice as high as it was last year and much larger than we have ever

seen at this time of year. Nevertheless, instances of lack of convergence have raised questions about contract design, which the CFTC and the exchanges are closely examining.

CFTC staff has also actively engaged with industry participants to learn more about their concerns regarding trading in our markets. Although staff has confirmed industry complaints that merchants and elevator owners have restricted the amount of fixed-price forward contracting from farmers, we have not seen diminished aggregate short hedging in forward futures months. Analysis of large-trader data currently shows a greater amount of short hedging in wheat, beans, and to a lesser extent, corn, compared to this time last year, by the relevant commercial merchant categories. The CFTC continues to analyze this data and its implications – in hopes of finding ways to encourage more forward contracting by market participants.

Agriculture Commodities Overview

During the recent increase in agriculture futures prices, Commission staff has been talking with virtually every segment of the agricultural industry—producers, cooperatives, grain elevator owners, merchandisers, exporters, millers, trade associations, and the futures exchanges. Using the Large Trader Reporting data, we are tracking trends in the market and analyzing participation in the markets in an effort to understand what is driving these unprecedented prices.

Corn and Soybeans

Generally, planting intentions are an important factor in agricultural markets, and have become even more important because of shifts of acreage caused by growth in demand for corn for ethanol production. About 4 billion bushels of corn will be used to produce ethanol in 2008 (about one-third of the 2007/2008 crop), as seen in Chart 2.

U.S. CORN USED FOR ETHANOL

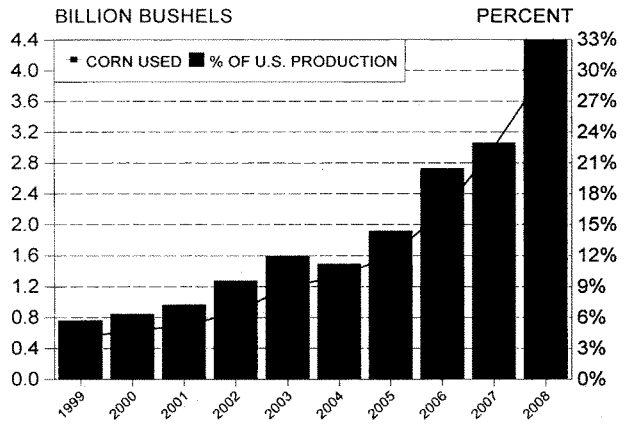


Chart 2: U.S. Corn Used for Ethanol

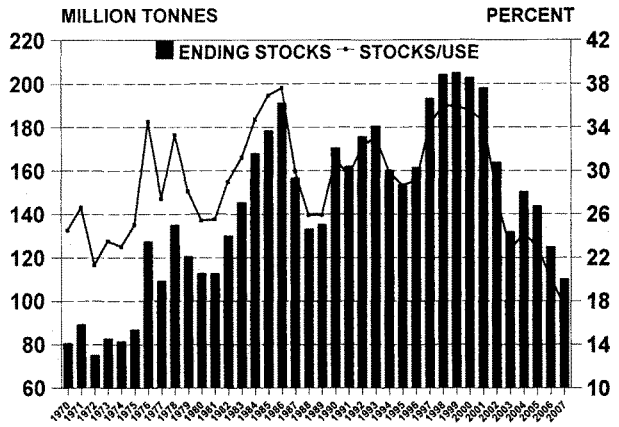
As land has shifted from other crops to corn production to meet this demand, it has had a ripple effect on prices of competing crops. Both corn and soybean prices have been unusually strong—indeed at record levels—despite bountiful harvests of both in 2007. From the most corn acreage planted since 1944, the last corn harvest was a record, exceeding 13 billion bushels. Despite the fact that corn plantings displaced nearly 12 million acres of soybeans, the soybean crop was plentiful (with strong yields from both North and South America). Coupled with a very large carryover from the 2006/2007 crop, we started the 2007/2008 crop year for soybeans with large supplies. Nevertheless, corn and soybean prices have risen since the 2007 harvest to record levels, generally reflecting strong global demand, geopolitical decisions to restrict food exports, weather concerns and projected tight supplies later this year. For example, the ending stocks for soybeans this year are projected to be one of the lowest in the past three decades.

Wheat

The supply/demand fundamentals for wheat have been very strong. There were poor wheat crops in major growing areas of the world last year, capped off by the second year of drought reduced harvests in Australia (13 million metric tons (MMT) versus a normal 20 MMT). In the U.S., the soft red winter and spring wheat production were of reasonable size historically, but the hard red winter crop was damaged by late frosts, which resulted in poor protein content and lower quality in other categories. The USDA is projecting the lowest carryover of wheat stocks in 30 years and the lowest world

wheat stocks-to-use ratio in recorded history. Chart 3 illustrates that tight world wheat supply situation that has caused high global wheat prices.

WORLD ALL WHEAT ENDING STOCKS AND STOCKS-TO-USE RATIO 1970/71 THROUGH 2007/08



2007 WORLD ENDING STOCKS ARE THE LOWEST SINCE 1977 AT 110 MMT (4.04 BILLION BUSHELS)
WORLD STOCKS TO USE IS THE LOWEST ON RECORD AT 17.7%

Chart 3: Historical Wheat Stocks and Use

With world stocks of wheat historically low, the market is especially vulnerable to shocks regarding planting intentions for the coming year. Wheat prices in late 2007 were somewhat inflated following the poor October 2007 harvest in Australia and the market expected much larger fall plantings of U.S. winter wheat to follow. However, when the monthly USDA Supply and Demand Report (released on January 11, 2008) revealed that fall plantings were lower than expected, both U.S. and global wheat market prices rose sharply. The response spilled over into the corn and soybean markets as well, since increased wheat prices signaled that additional wheat plantings would likely shift acreage away from corn and soybeans to spring wheat.

Wheat is an essential food staple, and its demand is relatively price inelastic – meaning price changes have little impact on demand. Indeed as we saw this winter, U.S. millers and foreign buyers bid up prices for low physical supplies of wheat, particularly high protein varieties, to extraordinarily high levels. Hard red spring wheat cash prices rose to over $20/bushel, at one point leaving the limit-locked Minneapolis Grain Exchange (MGEX) futures contract far behind. Durum wheat cash prices rose even more sharply to over $25/bushel, both in the U.S. and Canada. These examples are notable because MGEX wheat futures have no index trading and durum wheat has no futures contract, leaving supply/demand fundamentals as the likely cause of such run-ups in prices.

Exports are another indicator of abnormally high demand. Despite high prices, U.S. exports to both wealthier countries like Japan and poorer countries like Egypt continue. Overall U.S. wheat exports are up 40 percent over last year, and include exports to North Africa and the Middle East, markets mostly served by Europe and Ukraine for the past few decades.

Cotton

During 2007 and 2008, cotton prices have lagged behind prices for many other crops. Although acreage planted to cotton was down by 29 percent in 2007, record yields resulted in a relatively large crop of 19.2 million bales. Consumption (domestic use and exports) of U.S. cotton for this year will be around 18.8 million bales, so projected season ending stocks will increase by .4 million bales to 9.9 million bales, a relatively large level, equivalent to about 53 percent of annual consumption. Despite the relative abundance of cotton stocks, cotton futures prices also rose sharply beginning in mid-February. Some market commentary attributed the rise in cotton prices to expectations that there would be a further loss of about 12 percent of acreage planted to cotton in 2008, acreage lost to other crops with relatively higher prices. At the recent CFTC agriculture forum, some cotton market participants were less convinced that market fundamentals were the cause of those price moves. CFTC staff continues to closely study the data and circumstances surrounding this time period with these markets to ensure that prices were not artificially inflated.

Energy Products Overview

Similar to the agriculture markets, the energy markets, particularly crude oil, have also experienced a marked increase in futures prices during the past couple of years. The Commission's oversight of oil futures trading focuses on two markets: primarily on the New York Mercantile Exchange (NYMEX) and secondarily on the Intercontinental Exchange Europe (ICE Futures Europe) – the latter because one of its contracts cash settles on the price of the NYMEX WTI Light Sweet Crude futures contract.

Crude Oil

Crude oil prices have risen significantly during the past few years and are currently above $120/barrel. Concurrently, open interest in WTI crude oil futures has expanded dramatically, growing from about 1 million futures equivalent contracts in 2004 to about 3 million contracts during the most recent week.

We have studied these markets to better understand the components of this rapid growth and our studies find three major trends in crude oil markets. First, we see large increases in the use of futures contracts by both commercial and non-commercial interests. Commercial participants include those producing, processing, consuming, etc., the underlying commodity or otherwise managing risks related to the underlying commodity. Swap dealers, who use futures to hedge the risk of swaps on their book, are also classified as commercial traders. Non-commercial participants are commonly considered speculators. Growth across these groups has been largely parallel, however, with non-commercial share of total open interest increasing only marginally from 34% to about 36% over the past three years. It is important to understand that the majority of non-commercial positions are in spreads; that is, taking a long position in

one contract month and a short position in another. This is important because any upward pressure on price due to those long positions is almost surely offset by downward pressure from the short side of those spreads.

Second, much of the growth in open interest is concentrated in futures contracts that expire after 12 months. Whereas contracts beyond one year were rare in 2000, we are now seeing significant open interest in contracts with expiries out to five years and beyond. In fact, contracts extending beyond eight years are now available at NYMEX. Charts 4 and 5 below highlight these two trends.

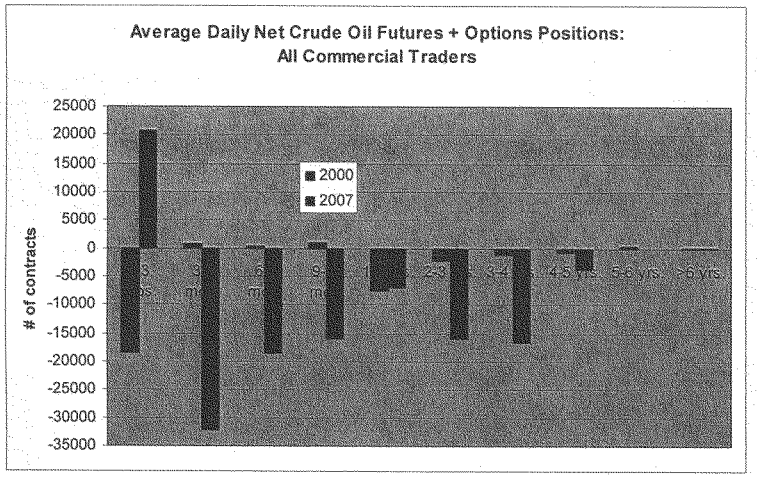


Chart 4: Trends in Commercial Trader Open Interest

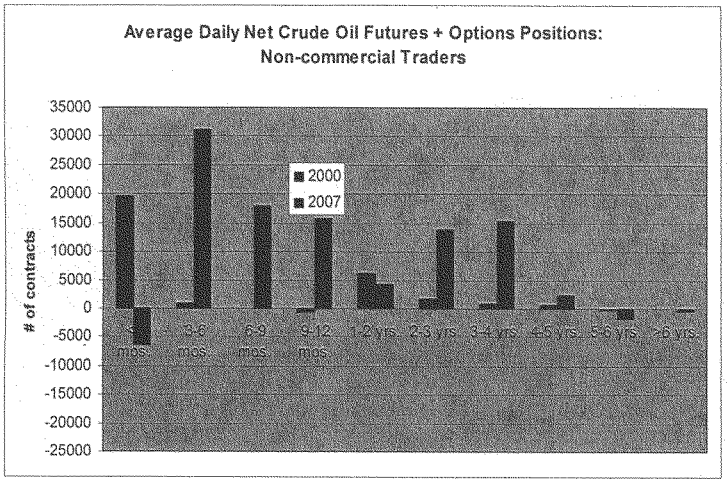


Chart 5: Trends in Non-Commercial Trader Open Interest

Charts 4 and 5 also highlight the fact that commercial traders generally take short positions to hedge and rely on non-commercial traders to take the opposite side of their trades. Thus much of the growth in non-commercial positions appears to be related to meeting the needs of commercial hedgers. Were fewer non-commercial traders willing to take positions opposite to commercial hedgers in distant contracts, hedging might not be feasible. The supply and demand for hedging services intimately ties hedgers and speculators together in futures markets.

The third major trend during the past few years in crude oil markets is that swap dealers now hold significantly larger positions in crude oil futures. These dealers, who sell over-the-counter swaps to their customers (such as pension funds buying commodity index funds or airlines seeking to hedge jet fuel costs), turn around and hedge their price exposures with long futures positions in crude oil and other commodities. This development has expanded the traditional role of commercial traders. Traditional commercial traders predominantly hedge long cash positions using short futures contracts. Conversely, swap dealers (also classified as commercial traders) frequently hedge short swap positions with long futures contracts. Charts 6 and 7 depict these differences.

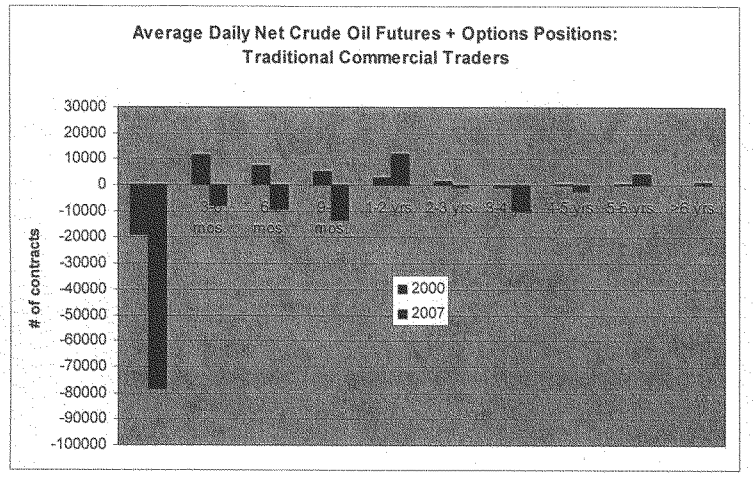


Chart 6: Trends in Traditional Commercial Trader Open Interest

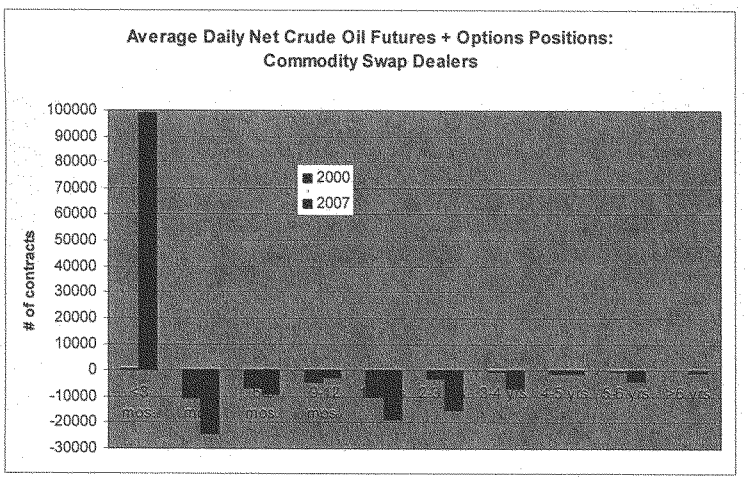


Chart 7: Trends in Swap Dealer Open Interest

Chart 7 also demonstrates that the growth in swap dealer trading in the near-term futures contract largely represents flows from commodity index trading.

Given the substantial increase in open interest in crude oil futures markets, OCE utilizes the Commission's extensive data to examine the role of all market participants and how their positions might affect prices. Although longer-term studies show a slight increase in non-commercial market share in the crude oil futures market, OCE analysis shows that the more recent increase in oil prices to levels above $120/barrel has not been accompanied by significant changes to the participants in this market. Chart 8 shows that the number of commercial and non-commercial traders has remained nearly constant over the past 22 months, with about 120 commercial and 310 non-commercial participants in the market.

Number of Market Participants in
NYMEX WTI Crude Sweet Oil Futures Markets

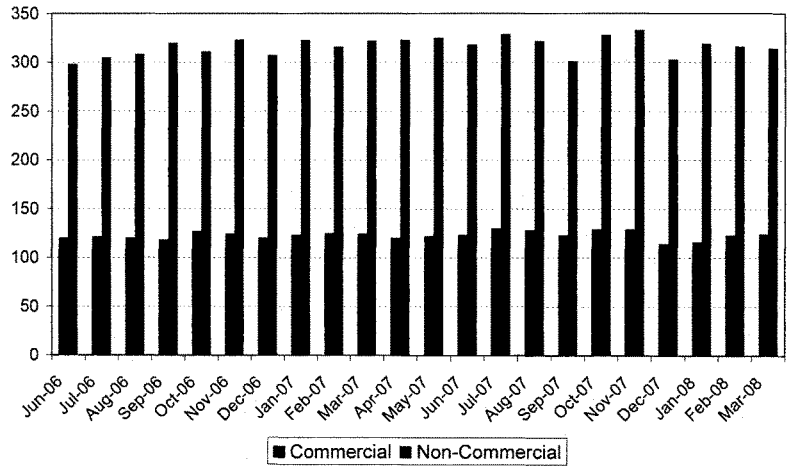


Chart 8: Commercial vs. Non Commercial Participants

OCE has also studied the impact of speculators as a group in oil markets during the most recent price run-up. Specifically, we have closely examined the relation between futures prices and positions of speculators in crude oil. Our studies consistently find that when new information comes to the market and prices respond, it is the commercial traders (such as oil companies, utilities, airlines) who react first by adjusting their futures positions. When these commercial traders adjust their futures positions, it is speculators who are most often on the other side of the trade. Price changes that prompt hedgers to alter their futures positions attract speculators who change their positions in response. Simply stated, there is no evidence that position changes by speculators precede price changes for crude oil futures contracts. Our tests cover various time frames and intervals from one to five days. When evidence does show that a group of trader positions precedes price changes in these tests, commercial trader group positions are those found to significantly precede crude oil futures price changes.

To highlight this fact more clearly, Chart 9 plots the prices and the market share of one group of active speculators (managed money traders) over the past 22 months. Notably, while WTI futures contract prices have more than doubled during the past 14 months, managed money positions, as a fraction of the overall market, have changed very little. Speculative position changes have not amplified crude oil futures price changes. More specifically, the recent crude oil price increases have occurred with no significant change in net speculative positions.

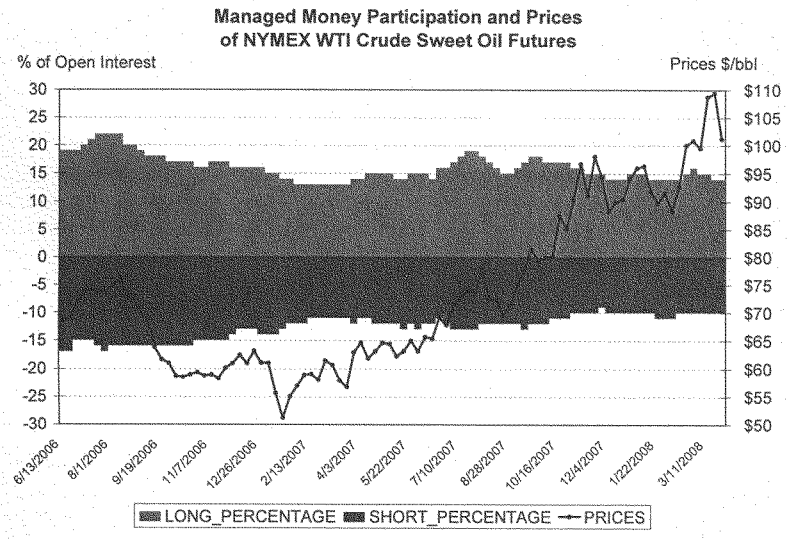


Chart 9: Managed Money Participation

OCE has also studied position changes of commercial and non-commercial traders by category, finding similar results. In no case do we find net position changes of any category of non-commercial traders preceding significantly changes in crude oil futures prices. Chart 10 highlights the fact that commercial and non-commercial open interest has grown during the most recent 22 months, but generally remains balanced between long and short positions for each trader group.

Traders' Open Interest in NYMEX WTI Crude Sweet Oil Futures

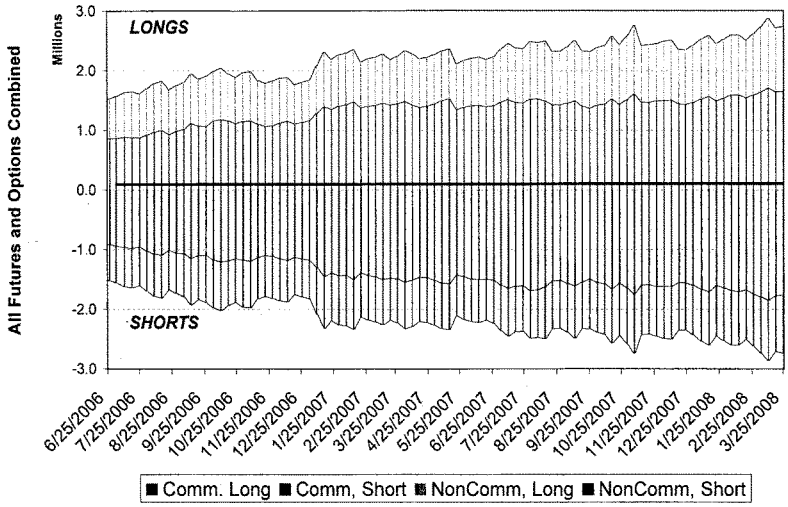


Chart 10: Commercial vs. Non Commercial Open Interest

Natural Gas

Increasing demand for electrical capacity continues to exert upward pressure on prices for natural gas. Recent NYMEX prices for June deliveries are near $11.30 per MMBTU (million British Thermal Units), about 73% higher than the corresponding price three years ago.

We compare April 2008 participation in the natural gas contract with participation in April 2005 in Charts 11 and 12. In April 2005, non-commercial participants held 47% of the open futures positions, with hedge funds comprising the majority (31%) of those positions. In April 2008, non-commercial participation increased by a modest 5%, with 3% of this increase coming from hedge funds. These aggregated figures suggest that speculative participation in natural gas futures has not grown substantially while prices have risen more significantly during the past three years. Nevertheless, the Commission's surveillance staff closely follows this market to ensure that all the participants act appropriately and the market is functioning as intended.

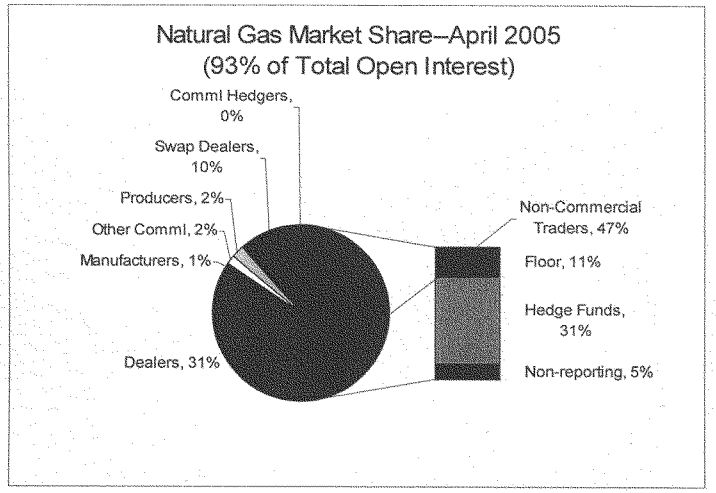


Chart 11: Natural Gas Market Share April 2005

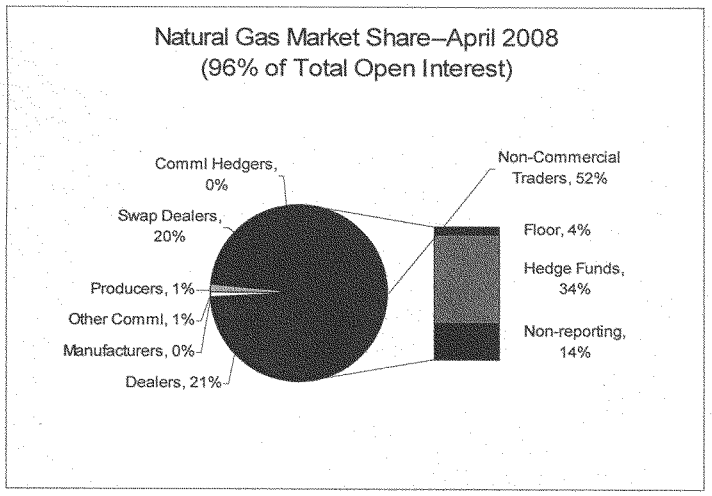


Chart 12: Natural Gas Market Share April 2008

Conclusion

Some observers have suggested that higher crude oil and agriculture commodity futures prices are being driven by speculators in the financial markets, and have suggested steps to reduce or limit their actions in the markets. As you can see, the CFTC has been actively engaged with industry participants during this time of extraordinary price increases. In addition, we have utilized our comprehensive data to rigorously analyze the role of investors (both hedgers and speculators) in both energy and agriculture futures markets.

All the data modeling and analysis we have done to date indicates there is little economic evidence to demonstrate that prices are being systematically driven by speculators in these markets. Generally, the data shows that:

- Prices have risen sharply for many commodities that have neither developed futures markets (e.g. durham wheat, steel, iron ore, coal, etc.) nor institutional fund investments (Minneapolis wheat and Chicago rice).
- Markets where index trading is greatest as a percentage of total open interest (live cattle and hog futures) have actually suffered from falling prices during the past year.
- The level of speculation in the agriculture commodity and the crude oil markets has remained relatively constant in percentage terms as prices have risen.
- Our studies in agriculture and crude oil markets have found that speculators tend to follow trends in prices rather than set them.
- Speculators such as managed money traders are both buyers and sellers in these markets. For example, data shows that there are almost as many bearish funds in wheat and crude oil as bullish funds.

Given the widespread impact of the higher futures prices, the CFTC will continue to collect and analyze our data closely, including continuing discussions and work with academic institutions, industry experts and other government experts and economists. In the past few months, the OCE and surveillance staff have conducted dozens of different analyses to examine our markets. We will continue to do that type of work to ensure we're taking a full view of the marketplace. In addition, I encourage others with data and findings different than ours to share that with us.

It is critical to recognize that speculators provide valuable liquidity and information to the futures markets, and this helps reduce the costs of hedging and risk transfer for market participants. Simply put, the economic data shows that overall commodity price levels, including agriculture commodity and energy futures prices, are being driven by powerful fundamental economic forces and the laws of supply and demand. These fundamental economic factors include increased demand from emerging markets; decreased supply due to weather or geopolitical events; and a weakened dollar. Together, these fundamental economic factors have formed a "perfect storm" that is causing significant upward pressure on futures prices across-the-board.

At the Commission, we are devoting, and will continue to devote, an extraordinary amount of resources to ensure that futures markets are responding to fundamentals and are serving the role of hedging and price discovery. Thank you for the opportunity to testify before you today and I look forward to answering any questions.

The CHAIRMAN. Thank you, Mr. Harris. And the chair will now recognize himself for 5 minutes for questions. Mr. Harris, much of the CFTC's analysis regarding index fund activity and commodity markets has led the Commission, as you said, to believe that index funds are not the cause of price increases we have seen in the commodity markets recently. I don't have any evidence to challenge that assertion. However, I wonder if there is still not subtle but distinct influence the funds do have on the market, and this leads to this question. Given that these funds are generally taking long positions, big dollars, generally are passively managed and generally are putting a great deal of money into the markets, while they may not be directly causing commodity prices to increase, could they not be preventing prices from following their natural order of moving up and down or following the supply and demand curve?

Mr. HARRIS. Actually that is one possibility that we are trying to assess here. What we have been doing in our analysis is looking at, from day to day, what the price changes are and what the position changes are by various groups of traders. Our public data groups traders broadly in terms of non-commercial and commercial traders. We can look at, and particularly in agricultural markets, the group of traders called index traders, and what we do as a simple analysis is this: we look at days the price goes up, and look who is buying on those days. And, in fact, that is one of the reasons we come to the conclusions we do. Usually when prices are going up, it is in response to trading by commercial dealers, whether it be manufacturers, producers, or dealers within the commercial space.

The CHAIRMAN. Well, I raise this question because I think it raises a question whether or not these long positions by not moving, just staying there, are really establishing the floor that we traditionally think the speculators, people who are in the market for the right reasons, are moving in and out. If you aren't going to move in, you have established, and you are assuming these two will keep moving, and obviously as long as the market keeps moving, you keep that floor up where it can't go up and down. So, it is automatically a moving market, and that raises a question does it really put more money in the market when you are doing that.

Mr. HARRIS. Well, that gets at the fundamental notion of what futures markets do, and one of the things I am not sure we have a great handle on is the psychological factor. The one thing that is true about futures markets, they are not like stock markets where we have a finite amount of stock outstanding, and so when people come and want to buy stock they have to bid it out of somebody else's hand. The futures markets exist such that people can write new contracts on open interest. In fact, what we are seeing in our markets is if these commodity index traders come to the market to buy, it is not necessarily information driven trading that they are doing. In fact, they don't necessarily have to go to the market and bid up prices. We could all write new contracts to those people and add liquidity into the market that way.

The CHAIRMAN. Okay. Let me get one more question before my time runs out because we get a little concerned. We had the bubble of tech stocks in the 1990s and housing at the turn of this century, and the last thing we want to do is see the farmers back in the

dust bowl. One piece of legislation introduced in the Senate is the Consumer-First Energy Act of 2008. One piece of this bill would require the CFTC to increase margin requirements for those trading in crude oil. And I believe you have been quoted as saying about such a proposal what it would do to impact—it would really force small market participants out leaving the market to only the very large hedgers or big speculators. I invite you to comment a little bit more on that before the Committee, if you would.

Mr. HARRIS. Yes, I think my viewpoint there actually comes from in the agricultural markets where we saw problems with meeting margin calls this past year when wheat was going up and limit up on a number of days in a row. We saw a bunch of small grain elevators actually having issues with financing, establishing lines of credit, and that is sort of the parallel position. It wasn't the big traders that had the issues with margins and margin costs because they were well capitalized. I think if we apply higher margins across the board to any market, it has the natural effect of adding a fixed cost of being in that market, and the fixed cost has to be borne obviously disproportionately by smaller participants.

The CHAIRMAN. Then my question comes to this very quickly as we close, is there a way the big traders can push the little folks totally out no matter what the margin call is if they want to drive it up to a point?

Mr. HARRIS. Well, in fact, yes, that is one of the things we do is to monitor these things, and, John, I think can speak to that in the market surveillance context.

Mr. FENTON. Yes. If a trader or a group of traders were colluding to drive prices up, that is the job of Surveillance to detect it and prevent. It is the job of our Enforcement Division to take action afterwards if we find that somebody has done that, so we are looking for that all the time. With regard to the margin question, I think from our point of view you first have to establish that there is a reason to do something different than what has been done for 100 years in margins; which is to set them to protect the financial integrity of the system; which they have worked brilliantly well to do, and there has been a great history of security in futures clearinghouses. So since we really don't think that the case has been made that speculation is driving prices, you are running the risk of unintended consequences to increase margins to a level that is beyond—a super margin level—that is beyond what is needed to protect the financial integrity of the system.

The CHAIRMAN. I would like to pursue that longer, but I have run out of time. I will yield to the gentleman from Kansas.

Mr. MORAN. Well, Mr. Chairman, thank you very much. On that point, when you say, Mr. Fenton, that speculation is not driving the prices, you may want to rephrase what I just said, but just a moment ago that was something similar to your words. Would you repeat that?

Mr. FENTON. I think that we haven't found evidence that speculation is driving prices in the agricultural market and in the energy markets.

Mr. MORAN. When you say that, what does that mean, that the price that is established in the market is based upon the laws of supply and demand, the so-called fundamentals that speculation

is—when you say it is not driving the price, what is the consequence of that? What does that mean?

Mr. FENTON. Well, I think it means that we think the market is reflecting fundamentals, that the——

Mr. MORAN. That is a desired outcome. That is what the market should—is that what the market should reflect in your mind, the fundamentals?

Mr. FENTON. Absolutely. That is the purpose of the market to discover the price based on fundamentals, but I would add to that it is not just current fundamentals but all futures markets are anticipatory. It is basically looking down the road and putting a probability estimate on things that may happen, and it incorporates that into the price, and that is again a very important benefit of futures market that it does do that.

Mr. MORAN. One of the oil company executives said within the last few weeks about oil prices based upon the laws of supply and demand oil should be priced at $55 a barrel, I think is what was said. What does that mean?

Mr. FENTON. Well, frankly, in my opinion that is living in a dream world. The price of crude oil has been going up persistently for 5 years, and there have been people who said that the futures market was getting it wrong, that prices should be at $40 or at $60 or at $80, and that each time it incorporated some level of speculative premium, $20 or something like that. And now looking back at price charts, you kind of think that the market really did get it right. You know, people would say, "Well, okay, back then when it was $60 maybe that was justified." So I think the evidence over time is that the market has been more correct than the critics of the market.

Mr. MORAN. Let me bring our conversation back to the agricultural commodities. I suppose there is a greater belief that wheat and corn reflect the so-called fundamentals in their price on the futures. But cotton, it seems to me, to be much more difficult to reach that conclusion, and we have had some what appears to be anomalies in the cotton market. Is there an explanation for what is going on there?

Mr. FENTON. I agree. I think cotton is an exception to what I have said. I think we have not found—the fundamentals in cotton are very different from the grains, and there was an episode, I would say, dating to mid-February through March where cotton prices went up sharply and chaotically, and really there was no current change in demand and supply. The market may have decided to look at expectations about coming year plantings and that there would be changes in supply down the road. But, we are currently carrying a very high level of stocks in cotton, so that is something that we are looking into. The Commission is pursuing a regulatory inquiry into what happened in cotton and why it happened.

Mr. MORAN. Do you have a list of what the possible explanations might be?

Mr. FENTON. Well, I think that in mid-February there was buying by both managed money traders—that is a sub-group of the non-commercial traders—and the large professionally managed money traders. They did buying during the middle days in Feb-

ruary, and the index fund traders also were buying at around the same time. There was buying pressure from financial money, but prior to the real explosion of price which occurred on March 3, there had been no significant buying by those two groups for about a week prior to that. And, in fact, on March 3 and 4 and subsequent days when prices were high and volatile the two groups that I mentioned, the managed money traders and the index traders, were not only not buyers but they were sellers.

Mr. MORAN. Mr. Harris or Mr. Fenton, if we didn't have the futures market, if we didn't have the speculators participating, would the price of commodities be less today than what we see in the market? Would the price of oil be something different, the price of corn be lower?

Mr. HARRIS. Well, I guess from my testimony, I think that is one thing we point out. There are commodities out there that have no futures contracts, and they are going up as much or more than the current commodities that have listed futures. And in fact there are commodities that have very little institutional money that are going up. The rice contract, for instance, is the record increase for the past year, and there is very little institutional money in rice.

Mr. MORAN. Thank you very much for answering me. Mr. Chairman, thank you.

The CHAIRMAN. I thank the gentleman. And I yield 5 minutes to the lady from Kansas, Mrs. Boyda.

Mrs. BOYDA. This is just fascinating. I have some questions, and I am not sure, they are not very well stated here. I am just trying to learn some stuff. On the sweet oil futures here that you had, do you have graphs? I know you were using this as an example. Do you have any graphs that are out there for the commodities?

Mr. HARRIS. Well, yes, I guess John presented an entire set of graphs at our agriculture forum, and we, I believe, have that.

Mrs. BOYDA. And we are talking about long and short contracts out here. Do you have the equivalent of this for sweet oil futures?

Mr. FENTON. The data that we have used to create this for crude oil, we have for all commodity markets, so we could do a similar graph writing for other commodity markets.

Mrs. BOYDA. And do they look similar?

Mr. FENTON. There is, I think——

Mrs. BOYDA. My question is we are not the oil committee, we are the Agriculture Committee, so I am wondering why are we—it is interesting, but why are we looking at crude oil?

Mr. FENTON. Well, I think because we have thought and think that crude oil is certainly on everybody's mind, and it is also an important component of agriculture input costs.

Mrs. BOYDA. In the interest of time, could you just get those to us?

Mr. FENTON. Sure.

Mrs. BOYDA. Okay. This is fascinating. I would like to learn.

Mr. FENTON. You asked if the similar chart for some of the agriculture markets would look similar. There is more spread trading in the crude oil markets. Spread trading is trading by a trader that takes a long position in 1 month and a short position in another. It is trading in differential. And that is the predominant trading activity of non-commercial traders in crude oil markets. There is

that in the other markets as well, but I think it is less in terms of the real world trading.

Mrs. BOYDA. Most are going still long, is that what you were saying earlier? It is all right because I only have 5 minutes. Do you have any way of knowing—I did 58 Congress On Your Corner events, it is fascinating, and you get to talk to everyone, and I have asked, "Has anybody seen $12 a bushel wheat, anybody paid $12 in my neck of the woods." Nobody that I have talked to in Kansas is getting these prices. So where are the differences going? I guess my question is do you have any sense of what percentage of the actual prices or what percentage of the money, the whole money, that is being invested spent, everything? What percentage of it is going to hedge fund managers as opposed to the farmer, any sense of that?

Mr. FENTON. Well, the amount of money going to hedge funds is obviously a function of the position they take and whether they are right about prices. The differential between a futures price and some cash prices, it depends where the cash price is, the location of the cash price. There is going to be a basis relationship between a cash market and a futures market that reflects both the time element and also the locational element. That is, it costs money to get a commodity from one place to another so——

Mrs. BOYDA. I don't have a lot of time. I apologize. But the perception is in my neck of the woods that our farmers aren't making the money. The hedge fund managers are making the money.

Mr. HARRIS. If I could make a comment on that.

Mrs. BOYDA. Yes.

Mr. HARRIS. One of the issues I think is the consternation among the farm community is that they looked at the futures prices going say from $6 to $8 and thought this is a good—"I can go out and hedge my crop and lock in a nice little profit here," and then prices continue to go up to $9, $10. We are then facing actually these margin costs so it costs them a little bit more in financing costs than they thought it would be. There is a common belief that there are methods of hedging and selling not your entire crop. These are extraordinary times, and I think that is true probably that the farmer didn't have perfect foresight for the most part and couldn't predict it. They probably wouldn't have hedged their commodity if they knew it was going to $10 and $12.

Mrs. BOYDA. And I guess that is what we are going back to, is there any manipulation there of saying it is our small farmers and ranchers, and clearly I have small farmers and ranchers. I have large farmers and ranchers in my district that are the ones that are being caught in the middle here. How much time do I have? Do you know, there are these rumors out there that these hedge fund managers sit at their computers and they basically bet and gamble on what is going on in Kansas. That there are basically formulae that are written that support these decisions. There are not people making decisions, that there are all these formulae, is there?

Mr. HARRIS. Well, it is certainly true that hedge funds both go long and short so they do take——

Mrs. BOYDA. Are there formulae out there?

Mr. HARRIS. Generally, yes, most hedge funds have some sort of program or they determine what the price should be. So if they say the price is too high or too low, they try to take a position both long and short in the market. One thing we do know is that they don't change positions all that often, so they tend to hold positions more than maybe the street lore would have it. Their trading activity is actually lower than the average in the markets.

Mrs. BOYDA. Thank you.

The CHAIRMAN. Thank you. The gentleman from Texas, Mr. Conaway, for 5 minutes.

Mr. CONAWAY. Thank you, Mr. Chairman. Getting back to the differential between cash market and futures market, do you guys watch that in terms of trying to analyze? I mean if it is just transportation cost or location, that is pretty easily done but is there—to expand on what Mrs. Boyda was saying, those differences in the cash market *versus* the future market, is that a trigger or a red flag for you in any way?

Mr. FENTON. Yes. It is a very important price relationship that we look at.

Mr. HARRIS. In fact, we have been monitoring that. In fact, being in touch with some of the University of Illinois researchers, we did a report on the Chicago Board of Trade 2 years ago on that particular issue, so we invited them to our ag forum. And we monitor these things and have been monitoring every contract and expiration for the last few years.

Mr. CONAWAY. What was your finding? Anything untoward involved or just the normal——

Mr. HARRIS. Well, one regularity actually in the basis risk is that the basis is actually—the futures prices—are lagging above the spot price during the expiration month up the Illinois River into Mississippi. At the Gulf Coast it is actually the opposite way so to us at the first glance or the first explanation would be that is a transportation cost issue. We have also collected information on barge rates and fuel, and we know that those costs have tripled or doubled in the last year alone. There does seem to be some fundamental explanation for some of that basis problem.

Mr. CONAWAY. Looking at this chart on the Minneapolis Exchange of wheat in over a relatively short period of time, what were you guys doing during that time frame from a regulatory standpoint to say, "It is okay to be happening like that, it is wrong, somebody is manipulating the system." Mr. Fenton, what were you doing on that wheat?

Mr. FENTON. We were intensively monitoring the trading. We were watching who was doing the buying and selling, and it is in a way illustrative of the fact that we have had high price movements and volatility—having in this case, very little to do with speculative trading. Speculators were not buying in this market during this period in a significant way, and index funds or index traders don't trade in the Minneapolis wheat market at all so——

Mr. CONAWAY. But who was buying at those prices?

Mr. FENTON. It was commercial firms.

Mr. CONAWAY. Firms that were trying to lock in the price for deliveries at that level?

Mr. FENTON. Or buying back short positions, and it is interesting that——

Mr. CONAWAY. You can tell that. You can tell if they are just trying to cover short positions.

Mr. FENTON. Absolutely.

Mr. CONAWAY. Okay.

Mr. FENTON. The cash price during this time period was at or above the futures price, and one of the features here was for a long period of time this market was locked. It reached the daily permissible price move and it was locked, and it was locked 15 out of 16 consecutive days, and so a lot of the pricing signals were coming out of the cash market.

Mr. CONAWAY. Any sense that the actual supply of wheat was driving this? In other words, was there a fundamental that said, "We are going to be short this particular type of wheat?"

Mr. FENTON. I think it is primarily being driven by demand, demand for—and maybe even panic demand to cover——

Mr. CONAWAY. You said panic demand?

Mr. FENTON. Covered needs. We know that millers and exporters or export buyers were bidding high prices to get wheat during this period.

Mr. CONAWAY. Why were they short wheat this year *versus* last year? There were people living this year but not doable.

Mr. FENTON. Well, I think in the case of—there is strong world demand for wheat and so it may well have been as people saw prices going higher, and they thought, "Well, it is high but I better buy it now, it may be higher later."

Mr. HARRIS. The difference, I think, between this wheat, this is the high protein hard red wheat so this is a unique commodity that is in high demand. There has been some evidence in Australia, for instance, that their wheat was probably short the last 2 years in a row.

Mr. CONAWAY. And you said in the rice market that is just insiders who—there are not other speculators in that market, you said?

Mr. HARRIS. It is not quite as clean as the wheat market where there is no index trading in wheat in the Minneapolis wheat but there is very little index trading in the rice market.

Mr. CONAWAY. And again rice market, you mean rice production around the world is down, up, sideways?

Mr. HARRIS. Yes.

Mr. CONAWAY. I gave you three choices. I said down, up, sideways.

Mr. HARRIS. Oh, it is down.

Mr. CONAWAY. Okay. I yield back. Thank you.

The CHAIRMAN. I thank the gentleman. The gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman, for holding this important hearing, and the fact that we are holding this hearing just less than 24 hours after completing the farm bill, which indeed was an arduous journey, is testimony to the importance of this issue and also the dedication of you, Chairman Etheridge, to this work. With the rapid increases and volatility in commodity prices, I think we have to take a careful look not only at the causes but as well as the consequences. I would like for each of you to very

quickly, if you could, in order of priority give me your opinion for the causes of this volatility, and then also in order of priority the consequences of these rapid increases in price.

Mr. HARRIS. Well, I think from an economic standpoint one of the things we see in all commodity markets is tremendous uncertainty about the future. We have two political events now of countries cutting off exports of food commodities in particular. We have seen a tremendous growth in the open interest from the hedging crowd so commercial traders who are on the buying end of these commodities in grains have bought more than ever. There is more shorting and locking in of futures prices by the farm community. We have record volumes in all of our markets. I should note that one of the exercises of margin calls in Kansas City, we did have a Kansas City Board of Trade member sell their seat to finance one of their positions, so that is an indication that the markets are booming as far as volume goes.

What is driving that demand, I think is just tremendous uncertainty about what is coming up. We see oil markets developing out now into 8 year contracts. We didn't have oil market contracts beyond 5 years just 5 years ago, and so there is some inherent hedging of demand or hedging of uncertainty in the future of trying to lock in prices using the futures markets.

Mr. FENTON. If I can add, there is of course more than one thing causing volatility, and it varies by market, but if I had to pick one thing that sort of spans many commodity markets, it is tremendous world demand for commodities especially coming out of emerging countries. China principally, in copper, in oil, in cotton although cotton is not a market that has strong fundamentals. If it wasn't for cotton and Chinese buying, cotton prices would be lower. So it is tremendously demand driven, and the consequence of these high prices, I would say, is it has made trading very difficult and short hedging very difficult. To have a short hedge on and to have done the right thing to hedge your risk and then face margin calls day after day is a very difficult position to be in.

Mr. SCOTT. Let me ask you both, what about the role of the institutional investors in the market? There seems to be quite a bit of blame that is geared their way. I would like for you to give your opinions on that, and also to comment on what I think are probably other more profound factors; which are the increased demand as you mentioned in developing countries, the weakening of the dollar, crop shortfalls, and this recent downward pressure on corn in terms of the production of ethanol. If we look at those, what would be your fair opinion, is it accurate as many in the community are doing to use the institutional investors as a scapegoat in light of these other causes?

Mr. FENTON. Well, I think there has been a growth of institutional money in the market. It has been, I think, mostly coincidental with the bull market and commodities. I think the things that you cited are powerful fundamental factors driving prices that demand for commodities around the world, the dollar weakness, and many crops of wheat in particular with the Australian drought, so many commodities are in short supply. And ethanol has really fundamentally changed the picture. Thirty million acres of American farmland now is devoted to producing energy really rath-

er than food, and so it has direct effects and indirect ripple effects throughout the ag economy.

Mr. SCOTT. Did you say 30 million acres?

Mr. FENTON. I am just basing it approximately a third of the corn crop is going to ethanol, and we use around 90 million acres to grow corn.

Mr. SCOTT. Is that new acres?

Mr. FENTON. No. Well, there has been some new acreage moved into corn from other crops, but it is acreage mostly that has been growing other things.

Mr. SCOTT. My time has expired. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. The gentleman from Texas, Mr. Neugebauer, for 5 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. I have a number of questions. I think the first question is that when you look at these graphs and the markets were edging upward, but then we had some very erratic behavior during a period of time there. If you look at these now some of these processes have come back down and seem to be a little bit more stable in their nature. And so I guess the question I have beginning with is was this some kind of a perfect storm that was going on where we were having some issues in other financial markets, people looking at moving liquidity around, looking for places to go, seeing the trend in the commodity process and say, "Hey, maybe that is the place for us to take money out of one place and go put it into another," and so all of that pressure kind of hitting the marketplace at one time. Mr. Harris, Mr. Fenton.

Mr. FENTON. They don't with some of that, and it does—many markets, certainly the wheat and soybean markets have come down quite a bit from their high of February and March. There probably was some of that money moving into commodity markets, but again we did not see, and looking at the data, do not see a massive in-flow of financial money into the commodity markets during this period that would explain these price rises.

Mr. NEUGEBAUER. The other question is I wish we could have seen here also over the same period of time what has happened to the dollar. American agriculture is a bargain when you look at other currencies around the world. In fact, everything is a bargain if you are buying American products because people are paying about $75 a barrel for oil in other countries. We are paying $110 a barrel just because of the differentiation of the dollar and the fact that oil is traded in dollars and some of these commodities. What would that chart look like as the dollar is going down, would it have been pretty much an inverse relationship in many cases?

Mr. FENTON. Yes. A while ago we looked at what oil prices would be if denominated in Euros compared to what it is denominated in dollars. It was about 25 percent less so we are judging using that back of envelope type analysis. That dollar weakness explains about a quarter of the increase in oil prices and probably similarly it would explain some of the increases in the ag markets.

Mr. NEUGEBAUER. Maybe we should send that message over to Chairman Bernanke and let him know that maybe he could help us with some of these oil prices and help strengthen our dollar. I think the other question I have is when I view these markets, par-

ticularly the commodity markets, I find them an extremely important tool for our producers around the country. When I think about what is their primary purpose, I have to think it is the commercial movement of commodities and the ability to do that in this country. Obviously, we need a certain amount of speculative activity in those markets to provide some liquidity. So if things are changing and we have this perfect storm, I think the question that all of us want to know today is, is this some kind of systemic change in these markets? Is it a time for reflection to make sure that these markets continue to provide that as an effective tool as we move forward?

Do we need to look at these structures and make sure that it is in place to be a tool? What I hear today from a lot of folks is that it is difficult to forward contracts for the little guy out there that is actually growing these commodities. I think sometimes we forget those folks. Those are the folks who are the most important. Are the tools in place for them? And I think some people are saying today that, "No, those tools are not in place because some of the things that have happened in the market have caused huge swings, volatility, margin calls that almost freeze up lines of credits for some of these folks." Do we need to stop and pause and reflect here and see if we are doing it right, or do you think we are doing it right?

Mr. FENTON. Well, first, I absolutely agree that the primary purpose of the futures markets is for price discovery and hedging. It is for people who are producing, consuming, or marketing commodities. And it has traditionally served that role very well. There is new trading in the market, index trading in particular is trading, that didn't occur in any significant way 10 years ago or even 5 years ago, so it is a new part of the market. And we are, and have been studying it, and we encourage others to—we do publish data on index trading. We started doing it last year in January. There are 3 years almost of data now available.

We encourage people to use it, to study it, to see if they see some impact of index trading on our markets. And unfortunately we don't get to stop the market. The market has to go on. But you are absolutely right that it calls for continued study to better understand these new types of trading in the market.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. Let me follow up as a prerogative of the chair for just a minute because I remember we had in the financial markets some of these things we didn't understand that we were trading in. Are you telling this Committee that some of this index stuff that we are trading in, you are trying to figure out what it is, and what we ought to be paying attention to? Are we not in a position to be able to have some regulatory authority over that, that is, trading that may be influencing some of the other stuff?

Mr. FENTON. I think this trading is not really complex. It is not an exotic engineered product. It is pretty straightforward. It is new though, and it is relatively new. It is in the past 4 or 5 years that it has been a significant factor in the market. And we think we have a pretty good handle on it, but have we completely answered does it have any impact in the market? Probably not. But our best

sense now is that we don't think that it explains the high level commodity prices.

The CHAIRMAN. We might want to come back to it. The gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman. Thank you for holding this hearing. We, Members of Congress, find ourselves sort of in between all of you all and the folks that we represent. In a district like mine what people see is increased gas prices, diesel prices, food prices general commodity prices. For an awful lot of the folks that I represent an increase of 10, 20, 30 percent in 30, 40, 50 percent, 60 percent, of a family budget is devastating, just devastating. And so naturally we are being assailed with all kinds of questions about what is going on. None of the answers seem particularly convincing to anybody because this has happened so suddenly.

I see on page two, your summary of the macro, micro economic forces at work here, that is basically the letter that I send out when people ask me about this. It doesn't satisfy folks. That is not surprising that it doesn't satisfy folks. I also see right after that, again on page two, your caution that you don't necessarily have the answers. That certainly doesn't comfort people. It doesn't comfort somebody like me. It is understandable. I accept that. But it is very difficult to send a letter back in response to somebody who is really hurting and not understanding this, saying, "Here are the forces generally, but we don't really understand what is going on." That is a very difficult position to take, and we are just looking for help up here.

And I got to tell you, it would be very helpful if I sensed a little bit more alarm than I sense. You know, for the families that are affected by this, this is a huge alarming phenomena that if the experts are saying we don't know, and it could go on for quite some time with sort of calm measured voices, that is not comforting at all. If you could flip to *Chart 9*, a quick question here. A lot of people have worried that the movement of money out of different asset classes and into other asset classes away from subprime mortgages, whatever it is, into this area is somehow causing all prices to move up. This is just a lot of capital in the world and capital looking around for security for investment opportunities, that sort of thing, perceived by ordinary folks not to be real, just rich people making money off a bad situation. That is how it is perceived.

And if you take a look at this, if I understood your testimony correctly, the idea here is that this chart suggests that people are taking short positions, long positions about equally, and so you shouldn't be too concerned. Yet I see the green is a lot more than the brown, and then on top of that, and we have seen this in the cotton business for sure, people taking short hedges worrying about having to make margin calls. I am going to have to sell my seat in the exchange to stay in the game. It seems to me that market would generally under these circumstances be saying, "Oh, my God, all this money is going to flow in here, prices are generally going to be driven high whether you call it," as somebody just said, "panic demand or not." Prices are going to go up so we better not be taking short positions here. There are a lot of investors out

there that are just going to park their money. It is going to be long. And that is a large part of the phenomena.

You know, there are just general consumption trends worldwide. You described that as well. That is something that we probably have to live with and adjust to. But to what extent can you safely say—well, what percentage? You estimated maybe 25 percent is a weak dollar. What percentage of this is just a whole bunch of money flooding into these different commodities?

Mr. FENTON. Well, before I answer that, could I just say that if my voice sounded calm or if our voices sound calm, it is not from a lack of concern. We are really busting our butts to be following these markets, and we take it very seriously. We completely understand the importance of this too.

Mr. MARSHALL. If I could just briefly interrupt. I think you guys do a great job of watching for market manipulation, conscious efforts, that are improper under our rules, criminal in some instances to manipulate the market for financial advantage. That is not what we are talking about here. I think we are talking about general trends that are very problematic for a huge hunk of our population, so, what percent?

Mr. FENTON. Well, I would say in my opinion the safe assumption in crude oil, which is the graph we are looking at, is that it is zero, that the market is reflecting—now obviously from day to day there may be days when particular trading, not by any means manipulative, but speculative trading may create a liquidity effect that moves prices but that would quickly abate over time. So I think the safe assumption is that the futures market is reflecting the fundamental reality of demand and supply for crude oil.

Mr. MARSHALL. And, Mr. Harris, you agree. My time is up so——

Mr. HARRIS. I think I would reiterate that we have the most detailed data in these markets than almost any market in the world. And I would agree. I think we see that the market seems to be functioning appropriately in reacting to demand and supply.

Mr. MARSHALL. Yes, we are all ears if you got some good ideas how we address this for these ordinary Americans who are really struggling as a result of this. And it is happening too soon to say that this is just sort of normal stuff. It is not. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. The gentleman from Louisiana, Mr. Boustany, for 5 minutes.

Mr. BOUSTANY. Thank you, Mr. Chairman. This is a very important hearing. I agree, a lot of American families are feeling tremendous anxiety, business owners are feeling anxiety, farmers, and so forth. And I think the importance of this hearing and the information we are getting is very valuable because we are getting some facts out there that we can all kind of get our arms around. And just to kind of review some of the things that came out in testimony and from further questioning, Mr. Harris, you said earlier little evidence that futures prices are driven by speculation, and then we kind of repeatedly heard that in other committees. And I think that should give some sense of comfort that we don't have this wizardry going on out there, that the markets are really being driven by fundamentals of tight supply and demand.

We know there is a linkage between energy and the other commodities. Clearly, the ethanol bridge and other things, the cost of inputs which largely related to petroleum products is also driving commodity prices. As well as problems such as what we have seen with rice in Thailand and other countries that have cut off exports. So basically the message that I am getting is that we have tight supply and demand. The fundamentals are driving the prices in this market. We know that the nature of the futures market is anticipatory. We know that hedging is a very important tool and that without arbitrage you can't really effectively hedge, so I think that the alarm that my colleague, Mr. Marshall, raises should not be something that Mr. Scott talked about, which would be "scapegoating", but really good policy that is going to address the tight supply and demand, and that is sort of where we are at an impasse here.

I can't help but think about the oil industry which I know a little bit about since I come from southwest Louisiana, and you mentioned the oil markets are looking at futures 8 years out. I know planning is a multi-year process with a lot of geopolitical risk, geologic risk, and so forth. I can't help but think that when the House voted four or five times in this past year or so to possibly impose $18 billion in new taxes on U.S. oil and gas companies, that can't be a good thing. It certainly has to have a detrimental impact on the planning process. And in a sense that is a type of speculation as well or a "speculatory" issue that could potentially create price increases down the line. Windfall profits tax, we have heard that kind of discussion as well with the oil and gas industry. We know what that did. We know what it did to us in the 1970s, and I would submit that if that sort of tax were imposed today the impact would be even worse because of the tight supply and demand situation that we are faced with.

So I guess I am pleased to hear the two of you today once again reiterate that fundamentals are driving this tight supply and demand, and that what we really need to do is look at ourselves, Democrats and Republicans, and face the fact that these are the facts here. We need to come up with good policies that, particularly in the energy industry, are going to help us increase supply as we transition to alternative fuels, which we know is going to be a lengthy process. I would submit we need to strategically manage our interdependence on fossil fuels today with good policy that emphasizes supply as well as future investment as we transition to hopefully alternative forms of energy.

So more of a speech than a question, but again I appreciate you again reiterating the facts about tight supply and demand. I don't know if you want to comment on that.

Mr. HARRIS. Well, if I could comment actually. One of the things that I want to make a point of is that we do have detailed trading data every day on who is buying and who is selling in these markets. We are rigorously analyzing these things, and on a weekly basis updating. In fact, we have most of this up through last Monday now sort of fully engaged in determining when does a psychological factor take over, does a psychological factor take over, what are we seeing on a day-to-day basis. The pattern that we saw actually in Minneapolis Grain isn't all that unusual for a market that

goes limit up. There is quite a bit of market behavior research that shows that when you stop trading in a market, you get more volatility when you start trading again. I think that is part of what might have happened in Minneapolis back in early March. But I do want to emphasize that we have information on who is buying and who is selling every day in these markets.

Mr. BOUSTANY. And I suppose it is safe to say that in a very tight supply and demand situation, you certainly are going to see more hedging going on, and so that creates the opportunity for more arbitrage. Is that an accurate statement?

Mr. HARRIS. Well, it is true that if prices were artificially driven high typically what you would see is a build up in inventory because nobody would want to buy those artificially high prices. In the grains that we highlighted in the written testimony here, we have historically low storage grain so there is a real reason that there is just not product out there to be able to buy so that seems to be driving the prices up.

Mr. BOUSTANY. Thank you.

The CHAIRMAN. I thank the gentleman. His time has expired. The gentleman from North Dakota, Mr. Pomeroy, for 5 minutes.

Mr. POMEROY. Thank you, Mr. Chairman. I commend you——

The CHAIRMAN. Excuse me, just a minute before you start. It looks like we are going to have a vote somewhere between 11:30 and quarter of, so we are going to try to stick to our time so we can try to get through with this panel and hopefully get the next group, get their testimony. The gentleman is recognized for 5 minutes.

Mr. POMEROY. Well, Mr. Chairman, it is a very important matter before us, but I am still a bit in afterglow on this farm bill vote. I commend you and especially the staff for the tremendous work we did on that. I agree with the comment made, I think it was by Congressman Scott, that the fact that we are moving directly immediately right into business shows the level of Committee concern about this whole range of issues. One of the things that I am worried about is the activity occurring in unregulated markets and whether or not CFTC has a handle on things the way they used to. The farm bill closed up the Enron loophole but still points to things we know and there are things we don't know. How do you try to get a handle on market activity at large, understanding that a lot of movement now is in the OTC unregulated area?

Mr. FENTON. Well, I think there it is by commodity. In the agricultural commodities, the OTC market is still pretty undeveloped, and in fact that was one of the reasons why we felt like we could put out accurate data for index trading in commodity markets. The swap dealers who do trading in the ag markets are predominantly almost overwhelmingly index trading, and we get to see that in the form of the swap dealer taking the position in the futures market. So I don't think that there is a significant chunk of activity in the ag space that is happening in OTC.

Mr. POMEROY. What about other areas under your regulatory control?

Mr. FENTON. I think in energy obviously the OTC market is a much bigger developed market, and there are OTC products traded on exempt commercial markets like ICE, and in the——

Mr. POMEROY. This whole thing has grown up since we addressed the Commodity Futures Modernization Act or whatever the name of it was, the Reauthorization Act. Go a year or 2 and have another hearing, and the whole marketplace will be different than the one I just studied about the last time we enacted, so this has been really—I am an old insurance regulator. You don't have anything moving like this in insurance regulation. I mean this is pretty phenomenal what has occurred in terms of the new activity occurring on these unregulated exchanges, correct?

Mr. FENTON. There is a big growth in the OTC.

Mr. POMEROY. Have you ever seen anything like that happen in your regulatory career?

Mr. FENTON. I would say there has been more growth in the last few years in the OTC market than have been in any previous——

Mr. POMEROY. The President's regulatory working group seemed to point to that we need to do something. We don't have a comprehensive handle on all this. I am just wondering, for example, it is not just within the country either. It is global. The global marketplace really is undifferentiated whether the trading is occurring in England or Georgia or wherever.

Mr. HARRIS. Well, if I could comment on that. I think one of the reasons I think the Enron loophole that we just hopefully will be closing soon is that development of a market. I can't speak specifically to the intent because I wasn't involved in the drafting of the legislation, but one of the issues in that legislation was to provide competition from electronic trading that we were seeing growing in the stock markets and other places in the United States. And ICE Futures in particular grew——

Mr. POMEROY. But my issue, do we have a handle——

Mr. HARRIS. I will get there. This is related because what happened then in ICE Futures was not reporting any of their trading to anybody, and the fix that we have in front of Congress right now is to have them report directly to us. That is not a directly parallel comparison to what we had——

Mr. POMEROY. That is good. What about England?

Mr. HARRIS. Exactly. So in the oil and crude markets right now ICE Futures UK trades a commodity related to our commodities traded here. We get weekly reports from ICE Futures from the FSA every week so that John's staff——

Mr. POMEROY. Is the report sufficient? They have kind of a different philosophy about regulation over there, it seems to me. Are you getting what you need to do to basically look at whether there is activity occurring in these other areas that might be of concern?

Mr. FENTON. I think the reports are sufficient to monitor for manipulation of the expiring futures. That was the purpose when we negotiated with the FSA and developed a pretty comprehensive information sharing and cooperative agreement with them.

Mr. POMEROY. I urge you—my time is rapidly expiring. I have one more question to get in the next 15 seconds. So I urge you to do more on that. I am interested in learning that, and I hope we will have a chance to further inquire on that. The last question, sovereign wealth funds. You look at speculator activity. Are you looking at a significant market presence coming in by another de-

velopment sovereign wealth funds and whether or not that is affecting market function?

Mr. FENTON. There is a very limited amount of trading activity by sovereign wealth funds directly. There is a likelihood that some trading going through managed money traders, commodity trading advisors, may be sovereign wealth funds money. But direct trading by sovereign wealth funds is pretty limited.

Mr. POMEROY. I would like to pursue that but another time. I yield back.

The CHAIRMAN. I thank the gentleman. The gentlelady from South Dakota, Ms. Herseth Sandlin, for 5 minutes.

Ms. HERSETH SANDLIN. Thank you, Mr. Chairman. Thank you for the hearing today. Thank you, gentlemen, for your testimony, and I would just like to build on the line of questioning that Mr. Pomeroy and Mr. Marshall were pursuing. If I am a cattle seller and I am going to the cattle auction, I am going to be a lot happier if there are about 15 bidders at the auction that day than if there are three. Prices for me if I am selling cattle that day are probably going to be significantly higher if there are far more bidders at the auction that day. It would seem to me that the same would hold if you are talking about expanding that to the oil futures market or the futures market for agricultural commodities.

So my question for you is how certain are you that the aggregate number of speculators in the market isn't driving up the price of oil which in turn drives up the price for the producers we represent?

Mr. HARRIS. Well, we are very confident. In fact, we can break out different types of speculators as well. We can break out the managed money traders from the index traders. We can aggregate as a whole, and that is exactly the analysis we are doing. I think an important point there is exactly that, that in the futures market there is an ability to write a new contract—so it is not like there is a single cow that we are all bidding on.

If you come to the market, and I come to the market at the same time, someone could write two contracts and give them to both of us so you can sort of split—you can get double the number of available supply in that case, so it is a little bit different than actual physical market in that sense.

Ms. HERSETH SANDLIN. I understand, and generally look for the marketplace to work effectively for our producers, we would rather have more bidders. This is sort of getting at what Mr. Pomeroy and Mr. Marshall are trying to get at in terms of: while the index trading may not be that complex; it is relatively new; and how we are breaking out the information. How the trading data in the futures market is being analyzed is raising a lot of questions. Particularly, when I think even your own examination has shown that there has been no visible evidence that any hedging operations are declining as a result of the rising financial obligations associated with hedging. Yet, we have had an increase in the aggregate number of speculators. I think it has tripled in the last number of years, and so I guess you are saying that you feel that the sophistication of your analysis suggests that there is absolutely no impact at all of that aggregate number of speculators in the market on prices.

Mr. HARRIS. I think the last graph in my written testimony, we have natural gas broken out in looking at, and that is exactly what we are looking at, the mix of traders. Even though speculative activity has tripled perhaps in some different markets, it is almost entirely mirrored by people on the other side hedging. So I think the speculator allows some liquidity in the market to afford that hedging activity to be executed on the market. I do think one good thing about the oil markets in general and sort of the explosion of volume in our markets suggests that a lot more of the over-the-counter market that used to exist that we never saw is actually being executed on exchange now. I think this credit crunch that we hit last summer is actually driving more of that trading onto the exchange. I am actually fairly confident that we are seeing more of the market now than we actually were in the past because of the fundamental soundness of the markets that we regulate.

Ms. HERSETH SANDLIN. Mr. Fenton, did you want to elaborate at all?

Mr. FENTON. Well, I think that in your analogy if you were at a cattle auction and you were a seller, you would like there to be multiple bidders. I think that certainly it is the case. It has always been true that one of the advantages of the speculator is that they provide liquidity so when you are offering to sell there is a bid there to buy. But as Jeff said, it is different in that there is a limited number of cattle to sell at an auction and there is an unlimited number of contracts that can be sold if something seems that the buying activity of an index fund is pushing prices to what seems like too high a level.

Ms. HERSETH SANDLIN. I appreciate your responses. Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. I thank the gentlelady. Let me thank both of you for being here. One question I would ask, and then each Member may have some questions they want to submit in writing. I do, but I would ask you to respond back to that within a week if at all possible. But I would like to know in following up what Mr. Pomeroy said with sovereign wealth funds and other things coming in the market, do you have the tools you need to do the job you need to do?

Mr. FENTON. Well, we are——

The CHAIRMAN. Yes or no. If you want to give me a written explanation, that is fine, but we want to get to the next one.

Mr. FENTON. We can do the job. We could use more tools.

The CHAIRMAN. You could use more tools?

Mr. FENTON. We need—I think it is a well-known fact that we are under severe budget constraints.

The CHAIRMAN. Okay. If you would share that with us in writing, I would appreciate that. Let me thank you for coming and we appreciate very much your testimony this morning.

Mr. BOUSTANY. Mr. Chairman, I am glad you asked that question. I would hope you get details as to what you would need to accomplish those goals.

The CHAIRMAN. He said he would within a week.

Mr. BOUSTANY. Thank you.

The CHAIRMAN. Thank you, gentlemen. And I will ask the second panel if they would join us. First will be Mr. Bob Stallman, Presi-

dent, American Farm Bureau Federation; Mr. Terrence Duffy, Executive Chairman, Chicago Mercantile Exchange Group; Mr. Gerry Ramm, President, Inland Oil Company, on behalf of Petroleum Marketers Association of America; Dr. James Newsome, President and CEO, New York Mercantile Exchange; and Ms. Laura Campbell, Assistant Manager of Energy Resources, Memphis Light, Gas & Water, on behalf of the American Public Gas Association.

And I am going to ask each one of you, if you will, we are going to try to get your testimony in before we have a vote that is upcoming. And if you would be kind enough, I know you have tried to get your statement to 5 minutes, we would ask you, if you can, to try to condense it to 4 if that is possible. We will be a little bit flexible on you, but if we can do that, I think we can get all of your testimony in, opening testimony, before we have to go vote. When we come back, we are going to have five votes so it will take a good while to get those votes in. You have been kind enough to sit through all this morning. I appreciate it. We have another panel following you in an attempt to get all of this in today, so thank you. We appreciate that. And with that, Mr. Stallman, you are welcome to start when you are ready.

STATEMENT OF BOB STALLMAN, PRESIDENT, AMERICAN FARM BUREAU FEDERATION; RICE AND CATTLE PRODUCER, COLUMBUS, TX

Mr. STALLMAN. Thank you, Mr. Chairman, and Members of the Subcommittee. I am Bob Stallman, a rice and cattle producer from Texas, and President of the American Farm Bureau Federation, and we are pleased to be here today to present some producer perspectives on what we are facing in the market. We are seriously concerned about the effective performance of the futures exchanges as mechanisms for price discovery and risk management. Over the past month, as has already been referenced, we have witnessed extreme price volatility, expanding and volatile cash/futures basis relationships, and hedgers difficulties in meeting margin calls.

The basic purpose of the Commodity Futures Trading Commission is to ensure that these markets under its jurisdiction operate in a way that allows us to manage price risk and discover cash prices. However, we believe that the market mechanism at this point is bent, if not broken, and the fact that several major grain and oil seed marketers are only offering firm crop price bids 60 days into the future is a rather ominous sign for the future. We have three main areas of concern. First, is lack of convergence between futures and cash prices. Convergence is the idea that futures prices by the close of the contract eventually equate to what is occurring in the cash market, also known as the law of one price.

Today, neither the convergence of futures to cash nor reasonable expectations of basis levels applies for a number of contracts. These developments challenge producers abilities to develop and implement risk management programs for marketing their products. The problem is compounded by the fact that many producers are being asked to make firm commitments for inputs far in advance of them using them and not being able to establish the price for the crop for which those inputs are applying. One reason we believe futures prices may not be making an orderly convergence is part of the

process established in 2000 when the river system delivery process was instituted by the Chicago Board of Trade. This system introduced the concept of a certificate of delivery that does not have to be redeemed by any certain date. Therefore, it provides little incentive for the actual physical commodity to move into the market.

Some possible solutions to the convergence may be: one, encourage the CFTC to require additional delivery points to prevent potential market manipulation and assure an adequate delivery system. Some of that is being done. Two, end the certificate of delivery and return to the notice process originally used for delivery. Three, examine the merits of cash settlement. Moving to a cash settlement contract should not be undertaken lightly, but we believe it merits further study. The second area of concern, the impact of higher margin requirements and expansion of daily trading limits. Volatility is at a record high and with already high trading limits and high margin requirements the average farmer has a very difficult time using the futures and options for price protection.

Last month we requested that CFTC analyze the possible effects on market participants of lowering the daily trading limits. We are not necessarily seeking to lower the price limits, but we believe a study would benefit participants by understanding: what the potential effects of margin requirements are; what the risk factors are; volatility; and what financing charges are coming in to play. Our third and last area of concern is the role of speculators and commodity index traders. As hedgers, we understand the importance of having speculative interest in the commodities markets. Market analysts report a continued though massive inflow of capital. It far exceeds what we have experienced in the past primarily by the long-only, passively managed index.

Trading activity by funds is certainly one of the contributing factors we believe to higher futures prices, and this ordinarily would appear to be positive, but if you don't get convergence with cash markets at the end of the contract there is little real information as to what the price level should be either for producers or consumers. Our AFBF policy opposes restricting speculative funds from the commodity markets because we do believe that they provide pricing opportunities and liquidity that might not otherwise be there.

We do have some concerns though that the volume may overwhelm the system at least to some extent with extreme levels of speculation. It is critical for hedgers to manage the price risk if they are going to do that to fully understand who is in the market, and perhaps more importantly, why. We are asking that additional transparency about the funds involved in the futures market should be required so that the markets can fulfill their primary functions of price discovery and risk management. In conclusion, let me just say we continue to support the CFTC's regulation of the commodity futures business. We vigorously oppose efforts to weaken the CFTC by transferring or reducing its authority or by combining it with the SEC as some have called for. Thank you for arranging this hearing, and we look forward to questions.

[The prepared statement of Mr. Stallman follows:]

Statement of the American Farm Bureau Federation

TO THE HOUSE AGRICULTURE COMMITTEE
SUBCOMMITTEE ON
GENERAL FARM COMMODITIES AND RISK MANAGEMENT

HEARING TO REVIEW THE SOURCE OF
DRAMATIC MOVEMENTS IN COMMODITY MARKETS

May 15, 2008

Presented by:
Bob Stallman
President, American Farm Bureau Federation

---

600 Maryland Ave. SW | Suite 1000W | Washington, DC 20024 | p. 202.406.3600 | f. 202.406.3606 | www.fb.org

Good morning, Chairman Etheridge and members of the subcommittee. I am Bob Stallman, a rice and cattle producer from Columbus, Texas, and president of the American Farm Bureau Federation (AFBF). We appreciate you scheduling this hearing to review recent dramatic movements in the futures market. AFBF is pleased to present producers' perspectives on turbulent market conditions and to share our views on an issue that is critical to our members.

As the nation's largest general farm organization and the representative of farmers and ranchers, from every state, AFBF has a vital interest in how commodity marketing issues affecting our members are perceived, examined and decided. We are seriously concerned about the effective performance of futures exchanges as mechanisms for price discovery and risk management.

Over the past months, we have witnessed extreme price volatility, expanding and volatile cash/futures basis relationships, and the difficulty of hedgers to meet margin calls. In addition, the role of speculative and commodity-index-related trading in agriculture futures markets, while growing for some time, has reached historic levels and added to the uncertainty in these markets.

The basic purpose of the Commodity Futures Trading Commission (CFTC) is to ensure that futures and options offered by the designated contract markets under its jurisdiction manage price risk and discover cash prices. However, the futures market mechanism is, at least, bent at this point in time, and the fact that several major grain and oilseed marketers are only offering firm crop price bids 60 days into the future is a rather ominous sign the breaking point might not be far away.

Lack of Convergence Between the Futures and Cash Prices

Convergence is the idea that futures prices by the close of the contract eventually equate to what is occurring in the cash market. It varies by commodity and geography, but historically the relationship between the cash and futures markets has been fairly constant with predictable seasonal variation. Certainly local market conditions might move the basis level around a few cents on any given day, but the underlying basis figures – predicated on the futures and cash markets coming together at the end of the contract – allowed all involved to function in a well-informed manner.

Today neither the convergence of futures to cash nor reasonable expectations of basis levels applies for a number of contracts. This is significantly increasing the risk faced by producers and will likely induce major structural change in the grain/oilseed/fiber handling sector over the next few months.

These developments challenge producers' abilities to develop and implement risk management programs for marketing their products. The problem is compounded by the fact that many producers are being asked to make firm price commitments for inputs. In some instances, they are even being asked to pre-pay for inputs they will not utilize until next crop year. This results in the uncomfortable position of producers locking in future input costs without similar opportunities in future crop prices.

Possible technical solutions to these issues could be implemented by the exchanges either voluntarily or via order of the CFTC. For example, one reason futures prices may not be making an orderly convergence to cash prices is part of the process established in 2000 when the river

system delivery process was instituted by the Chicago Board of Trade. This system introduced the concept of a certificate of delivery that does not have to be redeemed by any certain date. Consequently, there is little incentive for the taker to move the grain into the physical market and force convergence. There also has been much discussion regarding the exchanges' increasing the cost of carrying these certificates by boosting the cost of grain storage.

Some possible solutions to the convergence problem may be:

1. We encourage the CFTC to require additional delivery points to prevent potential market manipulation and assure an adequate delivery system. We note the Kansas City Board of Trade is currently in the process of increasing its wheat contract delivery points from two to four. We would encourage other exchanges to consider similar changes.

2. End the certificate of delivery and return to the notice process originally used for delivery against the futures contract. This should not cause any major disruption to futures trading. Once the change is made and traders realize delivery means actual physical acceptance of the commodity or that there will be some monetary penalty for re-tender, then we should see the orderly liquidation of open interest going into a contract delivery period. As we move toward contract expiration, we should see more orderly convergence.

3. An option which merits examination is cash settlement. There are cash-settled grain and oilseed contracts today; however, the volume for those contracts is probably too small to test this in practice. Moving to cash settlement should not be undertaken lightly, but it should be studied as a way to improve convergence.

Impact of Higher Margin Requirements and Expansion of Daily Trading Limits

Volatility is at a record high in the agricultural markets. With already high trading limits and high margin requirements, the average farmer has a difficult time using futures and options for price protection. Even larger commercial hedgers are having problems with financial liquidity.

Daily trading limits are of great interest to our members. While the rationale behind the increased limits is to let the markets clear and resume trading, in practicality, margin calls have become prohibitive. In fact, many hedgers simply do not have sufficient lines of credit to cover these high margin calls.

Last month, we requested that CFTC analyze the possible effects on market participants of lowering the daily trading limits. We are not necessarily seeking to lower price limits, but we believe a study of the potential effects on margin requirements, risk, volatility, and financing charges could be instructive for the exchanges and market participants, as well as the commission. A thorough economic review should examine adjustments that could reduce volatility while still allowing the markets to clear.

Role of Speculators and Commodity Index Traders

As hedgers, our members understand that speculative interest is an important component of any commodity market by facilitating its primary function of price discovery and providing market liquidity. Though speculators – including small investors – have always been integral to market

function, they are now playing an exponentially greater role than ever before. Market analysts report a continued, massive inflow of capital into the grain pits, much of it by long-only, passively managed index funds that buy futures and roll them forward according to a set schedule.

According to Chicago-based agricultural research firm AgResource Co., total index-fund investment in corn, soybeans, wheat, cattle and hogs has increased to $42 billion, up from just over $10 billion in 2006 – more than quadrupling in less than two years. That number doesn't even include the flood of index funds that have moved into other agricultural markets, primarily cotton, during the same period. Barron's estimated in its March 31, 2008, cover story that "index funds right now account for 40% of all bullish bets on commodities."

The recent level of long positions translates to the funds actually "owning" significant amounts of the entire U.S. corn, soybean and wheat crops. Independent analyst Steve Briese calculated at the end of March that index funds had effectively bought 36.6 percent and 62.3 percent of the 2007 domestic soybean and wheat crops, respectively.

Trading activity by funds is certainly one of the contributing factors generating high futures prices for commodities. Ordinarily, this would appear to be positive for agriculture. But if the futures markets do not converge with cash markets, there is little information on what real price levels should be either for producers or consumers of the commodity in question. With convergence, even if futures market prices fall precipitously in the delivery month, there are still economic signals being sent to which producers can respond.

In mid-March, index funds represented approximately 42 percent of the open interest in Chicago wheat, meaning that roughly two out of every five outstanding contracts were held by funds with limited need to trade on supply and demand fundamentals – they simply buy and hold. The result was a disconnect of the cash price (traditionally based on futures as a means of price discovery) from the high of the futures market. Forward contracting virtually ceased.

Historically, AFBF has supported open market participation and encouraged interest from speculators as well as hedgers, and we continue to support market involvement. However, our policy also supports CFTC oversight to ensure that market integrity is maintained and to curb practices that result in artificial price swings. In essence, it is up to the CFTC to ensure that participants do not prevent the futures markets from serving their roles as price discovery tools.

AFBF policy opposes restricting speculative funds from the commodity markets because they do provide pricing opportunities and liquidity that might not otherwise be available. We do not want to end speculative participation, nor do we believe the CFTC has or should be given that authority. Even if CFTC could restrict index fund investment activity, such an action could result in less liquidity and lower prices in the markets.

However, we do have some concern that from time to time fundamental price movements may be overwhelmed by extreme levels of financial speculation. It is critical for hedgers trying to manage price risk of the physical commodity to fully understand who is in the market and, perhaps more importantly, why. Therefore, additional transparency about the funds involved in the futures market should be required so that the markets can fulfill their primary functions of price discovery and risk management.

As you know, the CFTC is charged by Congress with ensuring the commodity markets do not become solely a speculative trading arena, rather than a price discovery/marketing tool for the agriculture industry. To that end, it must restore marketplace integrity with appropriate transparency.

Conclusion

We reiterate that we continue to support the CFTC's regulation of the commodity futures business. While there has been discussion of merging the CFTC and the Securities Exchange Commission in response to the volatile trading environment, we vigorously oppose efforts to weaken the CFTC by transferring or reducing its authorities, or by combining it with the SEC.

Thank you again for arranging this public hearing to better understand recent market happenings, and for allowing us to share producers' views of current issues. If additional authorities from Congress are needed in order to ensure future market functionality, we stand ready to work with you in that effort.

The CHAIRMAN. Thank you, sir. Mr. Duffy.

STATEMENT OF TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN, CHICAGO MERCANTILE EXCHANGE GROUP, INC., CHICAGO, IL

Mr. DUFFY. Thank you, Chairman Etheridge, Ranking Member Moran, and Members of the Subcommittee for holding this hearing and inviting me to appear before you today. CME Group is the world's largest and most diverse commodities market. Our products have served as leading global benchmarks for commodity prices for more than 150 years. We provide an important public service precisely because we operate a free market that permits risk transfer from hedgers to speculators in an open, transparent, and well-regulated marketplace. CME Group is a neutral facilitator of transactions, and does not profit from higher food or energy prices, increased volatility or speculation. Our core philosophy is to operate free markets that foster price discovery and the hedging of economic risks in a transparent and regulated environment.

Let me be clear that our markets are working. The Commodity Futures Trading Commission and most economists that have been surveyed agree that our markets are working and current price levels in energy and commodity markets are related to fundamental, macro-economic factors, not excessive speculation. One, biofuels are increasing commodity prices. As a result of U.S. legislation requiring 36 billion gallons of renewable fuels by 2022 approximately ¼ of the U.S. corn crop will be used to produce ethanol. Two, increased acreage for biofuels is limiting acreage for food crops. Farmers are economically rational. Last year they dedicated the most land to corn since 1944 as the demand for the ethanol sector boosted prices.

This diminished acreage devoted to wheat contributed to higher wheat prices. Three, the weak U.S. dollar has increased energy and commodity prices. The dollar's weakness against major foreign currencies has increased U.S. grain exports reducing domestic stocks and increasing prices. Additionally, our weaker dollar purchases less foreign oil than it did 1 year ago. Four, future projected demand exceeds future projected supply. The average annual growth rate and the production of grain and oil seeds has slowed from 2.2 percent per year in the 1970s and 1980s to only 1.3 percent since 1990. USDA projects further declines in the next 10 years. Five, greater affluence and changing dietary habits is driving higher meat consumption and further straining grain feedstocks.

As the demand for meat rises in China, India, and other developing countries, the demand for grain grows at an even faster rate. Six, droughts are limiting supplies. Multi and single year droughts in Australia, the Black Sea states, Canada and Russia have resulted in lower crop yields. Seven, export curbs and tariffs are limiting global supplies. Argentina, China, India, Pakistan, Russia, the Ukraine, and Vietnam have all suspended or cancelled wheat or other commodity exports or implemented prohibitive export tariffs in order to combat inflation or stabilize prices in their own home countries. Eight, inventories are low. U.S. wheat supply stocks are forecast by the USDA to be the lowest in 60 years and global wheat stocks are forecast to be the lowest in 30 years.

In summary, there is strong evidence that commodity prices are being impacted by fundamental factors. In contrast, there is absolutely no objective evidence that futures market speculators are driving higher prices. In fact, CFTC data demonstrates that index fund participation has remained relatively constant since 2006. Despite these facts and despite considered opinion of most economists, some have suggested limiting speculative activity in futures markets by artificially raising margin requirements for speculators. Government-mandated artificial margin requirements in futures markets will not limit speculative participation and will significantly disrupt the value of hedging and risk transfer services we provide.

We strongly believe that any proposal to artificially raise margin requirements will increase costs for speculators on both sides of the market, including the sellers; driving liquidity providers from regulated and transparent U.S. futures markets to unregulated dark pools in the OTC market or less regulated foreign markets. This is a net loss to the objective of fair, efficient, and well functioning commodity and energy markets. Interfere with the prudent risk management practices of central counterparty clearinghouses, performance bonds are designed to ensure the safeness and soundness of our clearing and settlement systems, not to create incentives or disincentives for trading decisions.

Rather than pursuing a flawed and harmful strategy of imposing artificial margin requirements on speculators and commodity or futures markets, we propose two useful steps for you to consider. First, we again recommend that the CFTC exercise its existing authority to eliminate exempt commercial markets originally authorized as part of the so-called Enron loophole. Under this trading loophole futures contracts based on energy, metals, and other nonenumerated commodities are traded in so-called dark pools without regulation. That means that speculators and commercial players can trade economically identical products in energy and commodities without position limits, position reporting, large trader reporting or transparency. CME Group strongly agrees with the recommendation of the President's working group which expressly found that unregulated trading in commodity and energy markets that are susceptible to manipulation is not appropriate.

Eliminating the Enron loophole would produce more effective regulation oversight without any adverse implications for innovation, competition, or market flexibility. More important, it would provide a better means of understanding, detecting, and deterring manipulative activity in exempt commodity and energy markets. Second, CME Group recommends the establishment of a joint task force by the CFTC and both U.S. Department of Agriculture and Energy. The task force should evaluate current cash market practices involving storage, delivery of commodities, as well as crude oil and gasoline and the impact of such practices on both cash and futures markets. Doing so will ensure that improper or undesirable activity is not falling in between the cracks of cash and futures market jurisdiction of these different Federal agencies. Thank you for your time today, and we look forward to working with you and your colleagues in Congress to insure our markets remain the envy of the world.

[The prepared statement of Mr. Duffy follows:]

Statement of
Terrence A. Duffy
Executive Chairman of CME Group Inc.
Before the
House Agriculture Subcommittee on General
Farm Commodities and Risk Management

May 15, 2008

I am Terrence Duffy, Executive Chairman of Chicago Mercantile Exchange Group, Inc., ("CME Group" or "CME"). Thank you Chairman Etheridge and members of the Subcommittee for this opportunity to appear here today to present our views on our markets and the role of speculators in those markets. CME Group was formed by the 2007 merger of Chicago Mercantile Exchange Holdings Inc. and CBOT Holdings Inc. CME Group is the parent of CME Inc. and The Board of Trade of the City of Chicago Inc. (the "CME Group Exchanges"). CME Group also owns Swapstream Operating Services Limited, an OTC trading facility, and owns an interest in FXMarketspace Limited, an FX trading platform that is authorized and regulated by the Financial Services Authority. The CME Group Exchanges serve the global risk management needs of our customers and those who rely on price discovery provided by the competitive markets maintained by the Exchanges. The CME Group Exchanges offer a comprehensive selection of benchmark products across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, agricultural commodities, energy, and alternative investment products such as weather and real estate. Additionally, we offer order routing, execution and clearing services to other exchanges by means of our Globex® electronic trading platform and our clearing house. CME Group is traded on the New York Stock Exchange and NASDAQ under the symbol "CME."

Walter Lukken, the acting Chairman of the CFTC, the Commission's economists and its enforcement staff – along with the economists, surveillance staff of the CME and CBOT – have carefully examined whether speculative trading on futures markets is exacerbating commodity prices. In testimony before the Senate Appropriations Subcommittee on Financial Services and General Government, Chairman Lukken provided a concise summary of the issue. He said: "These are extraordinary times for our markets with commodity futures prices at unprecedented levels. In the last three months, the agricultural staples of wheat, corn, soybeans, rice and oats have hit all-time highs. We have also witnessed record prices in crude oil, gasoline and other related energy products. Broadly speaking, the falling dollar, strong demand from the emerging world economies, global political unrest, detrimental weather and ethanol mandates have driven up commodity futures prices across-the-board. On top of these trends, the emergence of the sub-prime crisis last summer led investors to increasingly seek portfolio exposure in commodity futures. . . .To date, CFTC staff analysis indicates that the current higher futures prices generally are not a result of manipulative forces."[1]

The *Wall Street Journal* surveyed a significant cross section of economists who agreed that: "The global surge in food and energy prices is being driven primarily by fundamental market conditions, rather than an investment bubble . . . ."[2]

The U.S. Department of Agriculture's Economic Research Service recently studied the causes of increases in food commodity prices and concluded that, in addition to slower growth in production compared with rapid growth in demand, "...factors that have added to global food commodity price inflation include the declining value of the U.S. dollar, rising energy prices, increasing agricultural costs of production, growing foreign exchange holdings by major food-importing countries, and policies adopted recently by some exporting and importing countries to mitigate their own food price inflation."

---

[1] Oral Testimony of Walter L. Lukken, Acting Chairman, Commodity Futures Trading Commission Before the United States Senate Subcommittee on Financial Services and General Government Committee on Appropriations May 7, 2008 at http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opalukken-39.pdf.

[2] Bubble Isn't Big Factor in Inflation, By Phil Izzo (May 9, 2008; Page A2)

David Hightower, author of the "Hightower Report," summed up the supply/demand situation in corn last year as follows: "We have experienced three consecutive years of record corn production… and three consecutive years of declining ending reserves. Supply has put its best team on the field and demand keeps winning."

In short, the traditional production/consumption cycle that has governed prices in commodity markets is under stress from the confluence of a number of factors.

We have identified eight of the most significant factors that are influencing the supply and demand for grains and oilseeds. Each is important and deserves attention.

1. Biofuels;
2. Limited Farmland;
3. Weak Dollar;
4. Slower Growth in Production vs. Rapid Growth in Demand;
5. Additional Meat Needs More Grain
6. Drought;
7. Export Curb; and
8. Inventories

These critical factors combine to create volatile markets and increased prices. They are also driving structural change of unprecedented scope in the commodity markets.

1. Biofuels

The mandate to produce biofuels created additional market stress. The expectation is for continued growth in biofuel use/demand; politics rather than logic is at work - resulting in continued demand growth for feed grains and vegetable oils. To illustrate this point; the EU enacted legislation that will require significantly increased use of biofuel fuel by 2010. The problem is that there simply is not enough land to set aside in all of the EU to meet these ambitious requirements; they will need to import significantly higher levels of either finished product or higher levels of oilseeds in order to

produce the needed biofuel. Add to that the 2005 energy bill in the U.S. that spurred the rush to plant approximately 93 million acres of corn in 2007, the highest level since World War II. The USDA recently reported that corn based ethanol production will continue to rise placing additional demands on the crop: "driven by continued expansion in ethanol production capacity, corn use for ethanol is projected at 4.1 billion bushels 2008-9, up 28% from the current year projection. Ethanol corn will now account for 31% of total corn use, up from a projected 25% for 2007-8." The amount of corn used in ethanol production just 5 years ago was approximately 10%.

As we can see from this discussion, it is not just the supply side of the equation driving volatility in commodity markets any longer but unprecedented demand is starting to play a much larger role.

2. Limited Farmland

Farmers are intelligent and economically rational. Last year, farmers planted the most land to corn since 1944 as demand from the ethanol sector boosted prices. This year, farmers are forecast to raise their soybean seedings by about 18 percent to 75 million acres. To do this they will plant less corn: only 86 million acres compared to 94 million in 2007.

3. Weak Dollar

Since 2000, the dollar has depreciated by 28% as measured by the U.S. Dollar Index, which is comprised of six major currencies (Euro, Japanese Yen, British Pound, Canadian Dollar, Swedish Krona, and Swiss Franc). This decline in the value of the dollar, which is the currency in which international grain trade is conducted, means that commodity prices are, on average, 28% lower for these importers than they would be if the value of the dollar had remained constant during this period.

CME Group is also committed to redoubling its efforts to educate the banking community on hedging, and we have held discussions with the National Grain and Feed Association (NGFA) on jointly devising and implementing this new program. Too often we have discovered that many in the banking community do not fully understand the hedging of commodities

and as a result, are reluctant to extend credit when markets are volatile. We believe better understanding of hedging by bankers, while not likely to solve the credit crisis in agriculture, will certainly help the situation. In a few weeks, we'll kick off this effort with a seminar for Co-Bank employees from their regional offices in Denver, Kansas City and Omaha.

We will continue to review ways in which we may deliver some form of relief to hedgers who are experiencing difficulty with margin financing. We firmly believe that some of the restrictions currently imposed upon us relative to new product creation need to be reviewed. We believe that more creative product development in exchange-cleared OTC products may be one of many innovative solutions that should be allowed to address today's challenges.

4. Slower Growth in Production vs. Rapid Growth in Demand

The average annual growth rate in the production of grains and oilseeds has slowed from 2.2 percent per year in the 1970s and 80s to only 1.3 percent since 1990. USDA projects further declines in the next 10 years.

5. Additional Meat Needs More Grain

As the demand for meat rises, especially from fast-developing countries like China and India, the demand for grain and protein feeds grows at an even faster rate. In the short-run, GDP and personal income levels in the large emerging market countries such as India, China, Russia and Brazil are creating unprecedented per capita demand growth for animal protein. As is common in human history, as a society grows richer, its diet expands to include additional animal protein in the form of meat and dairy. According to a report on Bloomberg.com, worldwide meat consumption is forecast to increase by more than half by 2020; most of the new demand will come from China. The implications for grain demand will be staggering. Already in just the past 12 years, China has gone from a net exporter of soybeans to the world's largest importer of soybeans with soybean imports projected to easily exceed 30 million tons in 2007. Never before in history have we witnessed the impact of 2 billion people asking for a higher standard of living at the same time.

6. Drought

Multi- and single year droughts in Australia, the Black Sea states, Russia and Canada reduced wheat, barley and rapeseed production.

7. Export Curbs

During the last 3 months, there has been an ever expanding pattern of increasing export tariffs and decreasing import tariffs on grains and oilseeds by foreign governments. Russia extended a grain export tariff from April 30 to July 1. In addition, they have placed an export ban upon their grain to the four CIS (Commonwealth of Independent States) members designed to prevent re-export of Russian grain to third countries. Argentina extended their wheat export closure, and announced a sliding scale export tax based upon current prices. India increased its grain export tariffs while lowering import tariffs on edible oils. China has announced a further increase in edible oil imports in 2007-8 with projections currently up an additional 14%. South Korea announced the emergency lifting of import tariffs on 70 price sensitive products, including wheat and corn in an effort to confront rising inflation. The pattern we are witnessing is one of keeping domestic production off the global market while lowering barriers for the acquisition of grains and oils from the global market resulting in increased demand for U.S. grain and Oil Seed products.

Recently, The Financial Times quoted the UN Food and Agricultural Organization statistics stating that global imports of wheat from the period 2004/5 to 2007/8 increased by 91.7%.

According to the U.S. Soybean Export Council, there are over 14 countries that have just recently placed some form of higher tariff or an outright curb on grain exports.

8. Inventories

U.S. wheat surplus stocks are forecast to be the lowest in 60 years, and global wheat stocks are forecast to be the lowest in 30 years.

While the composition of our markets has not changed significantly in recent years, we are still cognizant of the need to ensure that our markets are performing well for our traditional market participants. As such, we want to proceed with prudence before deciding upon any changes to contract design or policies that may affect the current profiles of market users.

The CFTC requires that any changes we make to our contracts that could affect prices or price relationships be implemented beyond open interest or at the beginning of new crop years. Thus, we cannot make snap changes to our contracts. This is actually a positive rule as even a well functioning market will occasionally react unexpectedly to some market events. Our task is to provide a liquid and orderly market. This requires that we do no harm to a market by reacting too quickly – in effect, the prudent man rule. That said, when we gain solid evidence that a contract is not performing, we react quickly and decisively. Recall, as an example, the river delivery terms for corn and soybeans implemented in 1999.

We have worked with a broad spectrum of our customers to establish several contract changes that will be taking effect soon. They will, we believe, improve market performance. Storage charges will increase for wheat, beginning with the July 08 contract; storage charges will increase for corn, beginning with the December 08 contract; and storage charges will increase for soybeans, beginning with the November 08 contract. Also, in July of this year, the wheat delivery instrument will be changed from a warehouse receipt to a shipping certificate. This will expand the effective storage capacity of the wheat contract and improve convergence in the wheat market. We also have proposed increases to the corn and soybean load-out charges to better reflect the increased cost of elevation in the cash markets. All of these changes have been established through close working relationships with our customers.

We have made the following recommendations to the CFTC regarding participation in the grain and oilseed markets by non-traditional investors:

- We have requested that the CFTC defer consideration of increases in federal speculative position limits until additional analysis is completed – examining at the impact of increased limits upon the grain futures market performance.

- We also recommend that consideration by the CFTC of a new risk management exemption for passive investors be extended for a period of six to nine months while additional analysis of these proposed new regulations is conducted.

Additionally, we call on the CFTC to act as soon as possible to lift the prohibition on clearing of agricultural swaps products traded in the OTC market. We believe that lifting these restrictions will stimulate innovation in this sector that could help commercial firms better manage their price risk in the current challenging market environment.

We need to monitor global events, whether natural or government induced, that affect the supply/demand balance in our local markets. The United States serves as the principal provider of grain and oilseeds to the world. As such, our country represents the primary market for price discovery and risk management for the global grain and oil seed marketplace. We at CME Group work in close coordination with our customers and the CFTC to help ensure that our grain and oilseed markets continue to function effectively as we build for the future.

None of these factors seems to make the least impression on those commentators who demand an easy solution, which they claim can be mandated without cost or consequence. This vocal group, which does not include any competent agriculture economists, insists that driving speculators from the markets will bring prices back to a level that is more acceptable to these critics and better for the market. Worse still, the plan is to drive speculators from futures markets by government mandated increases in margins.

The proponents of this plan do not understand the role of speculation. They do not understand that there are speculators on both sides of the market. They fail to grasp that increasing margins to artificial levels is just as likely to drive prices to artificial levels. And they are oblivious to the fact that efforts to mandate price by direct price control, or by indirect actions, distort future production and cause costly misallocation of resources of production.

The imposition of artificially high performance bonds ("margins") will drive users away from transparent, regulated futures markets and into opaque, unregulated OTC markets. These OTC markets have less liquidity, less price transparency and no public accounting for traders' positions. This is a net loss to the objective of fair, efficient, transparent and well-functioning commodity and energy markets.

Performance bonds are designed to ensure that contractual obligations are met and that clearing houses can fulfill their responsibilities. They are not intended to create incentives or disincentives for trading decisions. Based on our strong track record of zero credit defaults in the 100-plus year history of CME Clearing, we believe our current system for calculating margin is the most prudent and sound approach to margining. Mandating arbitrary margin levels would not improve the functioning of commodity and energy futures markets. Moreover, it would interfere with the prudential risk management practices of central counterparty clearing houses.

Our extensive market regulation experience – and our experience with previous external efforts to control commodity prices by means of adjusting the level of performance bonds – has established that artificially increasing margins is neither effective nor responsible. Furthermore, there is no evidence that artificially increasing performance bonds will drive well-capitalized index funds or other passive long-only investors to sell. Nor is there evidence that the impact of any such selling would be beneficial or positive for hedgers and commercial users of futures markets. Congress should be skeptical of critics who argue to the contrary.

We look forward to working with Congress to educate the public as to the real drivers of price volatility and inflation and to create a sensible solution.

The CHAIRMAN. Thank you. Mr. Ramm.

STATEMENT OF GERRY RAMM, PRESIDENT, INLAND OIL COMPANY, EPHRATA, WA; ON BEHALF OF PETROLEUM MARKETERS ASSOCIATION OF AMERICA

Mr. RAMM. Honorable Chairman Etheridge, Ranking Member Moran, and distinguished Members of the Committee, thank you for the invitation to testify today. I really appreciate the opportunity to provide some insight on the extreme volatility and record setting prices seen in recent months on the energy commodity markets. I am an officer of the Petroleum Marketers Association of America. We represent over 8,000 independent fuel oil dealers and almost all of the heating oil dealers in the United States. Excessive speculation on energy trading facilities is the fuel that is driving this runaway train in crude oil prices. Last month Stephen Simon of ExxonMobil Corporation who testified before the House Select Committee for Energy Independence and Global Warming agreed that speculation is part of the problem stating, "When you look at the fundamentals, the price should be $50–$55 a barrel."

If you are a large party like a hedge fund or a sovereign wealth fund because of your balance sheet you can purchase high leveraged, unregulated bilateral energy trades. If this entity speculates with $1 million, they could get a 100 to 1 margin account for energy trades. If on May 13, 2008, where there was a 13¢ increase in heating oil, they could have netted a return of $3.6 million or 364 percent on that day of trading. The rise in crude oil prices in recent weeks have reached $127 on Tuesday, has dragged with it every single petroleum refined product, especially heating oil. In May, heating oil has gone up over 60¢ per gallon. This price spike occurred while heating oil inventories remained at or near a 5 year average.

While energy commodities continue to skyrocket petroleum marketers and consumers are forced to pay excessively high energy prices. We have come to the conclusion that excessive speculation on energy commodity markets has driven up the price of crude oil and consequently all refined petroleum products without supply and demand fundamentals to justify the recent run up. Large purchases of crude oil contracts by speculators have in consequence created additional demand for oil for which drives up the price of future delivery of oil. We have now moved beyond the previous inflation adjusted high of $104 in 1979, but without an equivalent disruption to oil availability that was experienced in those decades.

U.S.-destined crude oil and heating oil contracts are trading daily at the rate for multiple times the annual consumption of crude oil in the United States. We must have full market transparency. Speculators who have no direct contact with physical commodities are trading in the over-the-counter markets and the foreign boards of trade, which due to a series of legal and administrative loopholes, are virtually opaque. We want to thank you for passing the farm bill. That will help bring transparency to some of these energy markets. However, the farm bill is just the first step. The CFTC provided a No Action letter to a London-based International Petroleum Exchange, IPE, because it was regulated by the United Kingdom Financial Services Authority. Subsequently, IPE was

bought by the IntercontinentalExchange, ICE, located in Atlanta, Georgia.

ICE is the exchange most often utilized by those who exploit the Enron loophole. ICE is a publicly traded exchange whose shareholders are primarily investment funds. In recent years, ICE's trading volume has exploded at the expense of the regulated NYMEX. ICE purchased IPE and will continue to claim exemptions on various contracts whether or not the farm bill becomes law since they effectively get a "get out of jail free card." Closing the Administrative Foreign Boards-of-Trade Loophole via review or elimination of the CFTC No Action letters to overseas trading would be something that you may consider. Raising margins or necessary collateral for non-commercial entities or so-called non-physical players, requiring non-commercial traders to have the ability to take physical delivery of at least some of the products, imposing new transaction fees for non-commercial or non-physical traders are others.

PME strongly supports the free exchange of commodity futures in the open market, that we want well-regulated and transparent exchanges that are subject to the rules of law and accountability. Reliable futures markets are crucial to the entire petroleum industry. Let us make sure that these markets are competitively driven by supply and demand fundamentals. We and our customers need our public officials, including those in Congress and the CFTC to take the stand against the loopholes that are artificially inflating our energy prices. One other point I would like to raise is the pass through of the ethanol credit where now with oil companies at terminals doing injection blending they are not passing through the ethanol credit to their marketers or to their end-users.

So what we would like to see, we used to be able to splash blend but now we are not able to do that anymore, so we would like to see something on that too. Thank you very much for your time. I will answer any questions.

[The prepared statement of Mr. Ramm follows:]

Mr. Gerry Ramm
President, Inland Oil Company
Ephrata, Washington
On behalf of the
Petroleum Marketers Association of America
Arlington, Virginia

Testimony before the
Agriculture Committee
Subcommittee on General Farm Commodities and Risk Management
United States House of Representatives
Washington, DC

May 15, 2008

Honorable Chairman Etheridge and Ranking Member Moran and distinguished members of the committee, thank you for the invitation to testify before you today. I appreciate the opportunity to provide some insight on the extreme volatility and record setting prices seen in recent months on the energy commodity markets.

I am an officer on the Petroleum Marketers Association of America's (PMAA) Executive Committee. PMAA is a national federation of 46 states and regional associations representing over 8,000 independent fuel marketers that collectively account for approximately half of the gasoline and nearly all of the distillate fuel consumed by motor vehicles and heating equipment in the United States. I also work for Inland Oil Company in Ephrata, Washington. My Dad started Inland Oil Company in 1946 after he returned from duty in World War II. Today we operate 7 gas stations and convenience stores and we also supply fuel to 8 independent dealers. Also, supporting my testimony here today is the New England Fuel Institute who represents over 1,000 heating fuel dealers in the New England area.

Excessive speculation on energy trading facilities is the fuel that is driving this runaway train in crude oil prices. For example, on January 3, 2008, one floor trader bought 1,000 barrels; the smallest amount permitted, and sold it immediately for $99.40 at a $600 loss. The trader deliberately pushed the price of a barrel of crude oil over $100 just because he wanted to tell his grandchildren that he was the first person ever to buy crude oil over $100.[1] Last month, Mr. Stephen Simon of ExxonMobil Corp. who testified before the House Select Committee for Energy Independence and Global Warming agreed that speculation is part of the problem stating, "When you look at the fundamentals, the price should be $50-55 a barrel of oil. The weaker dollar, geopolitical risk, and speculation."

In addition, in times of a national crisis, excessive speculation can also exacerbate an emergency. An example of this comes from a Wall Street Journal article from September 2005, wherein an oil trader bragged about his profits following Hurricane Katrina. This futures trader bragged that some traders made enough money in one week following Katrina

---

[1] (BBC News, 2008)

that they would not have to work for the rest of the year. Comments like these concern PMAA members who argue that the recent volatility in crude oil prices will force small businesses and consumers to pay excessively high energy prices that do not reflect supply and demand factors.

The rise in crude oil prices in recent weeks, which, reached over $126 on May 9, 2008, has dragged with it every single refined petroleum product, especially heating oil. Wholesale heating oil prices from March 5, 2008 – May 6, 2008 have risen from $2.97 to $3.35.[2] The spike comes despite warmer temperatures in the Northeast. What is interesting is that Colonial Group Inc. which provides wholesale/retail petroleum fuels announced May 7, 2008 that it had 150,000 barrels of surplus heating oil available for auction. Ironically, heating oil futures set yet another record high that day with the June contract close with a 9.3 cent gain at 3.37 a gallon along with temperatures averaging in the upper 70s in the Northeast. The numbers just don't add up.

Excessive investor influence in the energy futures market has led to a bloated energy commodities market which contributes to artificially high oil prices. While energy commodities continue to skyrocket, petroleum marketers and consumers are forced to pay excessively high energy prices. Last year, gasoline and heating oil retailers saw profit margins from fuel sales fall to their lowest point in decades as oil prices surged. The high crude oil prices and volatility over the last few years are caused by geopolitical turmoil, China, India and other emerging economies demanding more oil, and finally, speculation by hedge funds and other investment funds that are moving money into energy commodities as a hedge against the weakening U.S. dollar.

According to a 2006 Senate Permanent Subcommittee on Investigations bipartisan report by Chairman Carl Levin (D-MI) and Ranking Member Norm Coleman (R-MN) entitled, *"The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat,"* "Several analysts have estimated that speculative purchases of oil futures have added as much as $20-25 per barrel to the current price of crude oil, thereby pushing up the price of

---

[2] Energy Information Administration, "U.S. No. 2 Heating Oil Wholesale/Resale Prices," March 5 – May 6, 2008

oil from $50 to approximately $70 per barrel. Who would have thought that crude oil futures would rise to over $126 a barrel?

PMAA has come to the conclusion that excessive speculation on energy commodity markets has driven up the price of crude oil (and, consequently, all refined petroleum products) without the supply and demand fundamentals to justify the recent run-up. Large purchases of crude oil futures contracts by speculators, have, in consequence, created an additional demand for oil which drives up the prices of oil for future delivery. This has the same effect that additional demand for contracts for the delivery of a physical barrel today drives up the price for oil on the spot market. Basically, a futures contract bought by a speculator has the same effect on demand for a barrel that results from the purchase of a futures contract by a petroleum marketer.

We have now moved beyond the previous inflation adjusted high of $104 in 1979, but without an equivalent disruption to oil availability that was experienced during that decade. U.S. destined crude oil contracts could be trading DAILY at a rate that is 18 times the rate of ANNUAL consumption, and U.S. destined heating oil contracts could be trading DAILY at a rate that is 8 times the rate of ANNUAL consumption. Imagine the impact on the housing market if every single house was bought and sold 18 times every day. An October 2007 Government Accountability Office report, *"Trends in Energy Derivatives Markets Raise Questions about CFTC's Oversight,"* determined that futures market speculation could have an upward effect on prices; however, it was hard to quantify the exact totals due to lack of transparency and record keeping by the CFTC.

To be able to accurately "add up" all of the numbers, you must have full market transparency. This is perhaps the biggest barrier to obtaining an accurate percentage calculation of the per barrel cost of non-commercial speculative investment in crude oil, natural gas and other energy products. Much of the non-commercial, i.e. speculators that have no direct contact with the physical commodity involvement in the commodities markets is isolated to the over-the-counter markets and foreign boards-of-trade, which, due to a series of legal and administrative loopholes, are virtually opaque. Therefore, we encourage Congress to:

1. Bring full transparency to energy trading environments by passing the Senate version of the "CFTC Reauthorization Act of 2008" (otherwise known as the Close the Enron Loophole Act) which is pending in the Farm Bill Reauthorization (H.R. 2419).

However, the Farm Bill is only a first step.

What the Farm Bill language DOES NOT do is repeal a letter of "no action" issued by the CFTC to the London based International Petroleum Exchange (IPE) which was subsequently purchased by the Intercontinental Exchange (ICE). The letter of no action was issued since the IPE was regulated by the United Kingdom's Financial Services Authority (FSA), which theoretically exercised comparable oversight of the IPE as CFTC did to NYMEX. Recently, however, whether or not the FSA exercises "comparable oversight" was brought into question by CFTC Commissioner Bart Chilton. Congress needs to investigate whether or not oversight by foreign regulators is "comparable."

ICE is the exchange most often utilized by those who exploit the Enron Loophole. ICE is a publicly traded exchange whose shareholders are primarily investment funds. In recent years ICE's trading volume has exploded at the expense of the regulated NYMEX. ICE purchased IPE and will continue to claim exemptions on various contracts whether or not the Farm bill becomes law since they effectively have a "get out of jail free card."

Congress and the Administration might also consider:

2. Closing the Administrative Foreign Boards-of-Trade Loophole via review or elimination of CFTC "no action letters" to overseas energy trading platforms. Off-shore exchanges should be subject to the same level of oversight and regulation as domestic exchanges such as the NYMEX when those exchanges allow U.S. access to their platforms, trade U.S. destined commodities, or are owned and operated by U.S. based companies.

3. Raising margin requirements (or necessary collateral) for non-commercial entities or so-called "non-physical players," i.e. commodities traders and investors that do not have the ability to take physical possession of the commodity, or otherwise incurs risk (including price risk) associated with the commodity either in connection with their business or that of a client. In other words, anyone who does not meet the definition of "eligible commercial entity" under

7 USC §1a (11). Currently, margin requirements in futures trading are as low as 3 percent for some contracts. To buy U.S. equities, margin requirements are a minimum of 50 percent.

4. Requiring non-commercial traders (e.g. financial institutions, insurance companies, commodity pools) to have the ability to take physical delivery of at least some of the product. (Rep. John Larson (D-CT) is considering such a proposal now).

5. Imposing new transaction fees for non-commercial or "non-physical" traders.

6. Banning from the market any participant that does not have the ability to take direct physical possession of a commodity, is not trading in order to manage risk associated with the commodity, or is not a risk management or hedging service (again, anyone that does not meet the statutory definition of "commercial entity" under 7 USC 1a(11).

7. Significantly increase funding for the CFTC, which the FY 2009 President's budget recommended $130 million. While this is an increase from previous years, CFTC staff has declined by 12 percent since the commission was establish in 1976, yet total contract volume has increased over 8,000 percent. Congress should appropriate sufficient funding to keep up with the ever changing environment of energy derivatives markets.

We and our customers need our public officials, including those in Congress and the CFTC, to take a stand against a loophole that artificially inflates energy prices. PMAA strongly supports the free exchange of commodity futures on open, well regulated and transparent exchanges that are subject to the rule of laws and accountability. Many PMAA members rely on these markets to hedge product for the benefit of their business planning and their consumers. Reliable futures markets are crucial to the entire petroleum industry. Let's make sure that these markets are competitively driven by supply and demand.

Thank you again for allowing me the opportunity to testify before you today. I would be happy to answer any questions you may have at this time.

Mr. MARSHALL. Mr. Chairman, why don't you suggest that Dr. Newsome vary from his prepared testimony and just respond to Mr. Ramm.

The CHAIRMAN. Dr. Newsome for 5 minutes, and then we may have to stop after that because we are running short of time that we got to vote on.

STATEMENT OF JAMES E. NEWSOME, PH.D., PRESIDENT AND CEO, NEW YORK MERCANTILE EXCHANGE, INC., NEW YORK, NY

Dr. NEWSOME. Thank you, Mr. Chairman. It is a honor to speak in front of this Subcommittee again. In a highly transparent, regulated, and competitive market, prices are affected primarily by fundamental market forces. The demand and supply fundamentals in the oil markets continue to be the driving factors in oil prices. The latest EIA Short-Term Energy Outlook summarized the demand and supply situation as follows, "The oil supply system continues to operate at near capacity and remains vulnerable to both actual and perceived supply disruptions. The combination of rising global demand, fairly normal seasonal inventory patterns, slow gains in non-OPEC supply, and low levels of available surplus production capacity is providing firm support for prices."

I wish to highlight this finding; growth in consumption has outstripped growth in non-OPEC production by over one million barrels per day. With projected demand exceeding one million barrels per day, the only way a market with highly inelastic demand will equilibrate is through a substantive rise in price. The upward price pressure has been there, and according to projections will continue to be there. It is key to realize that the market tightness and the market struggle to discern actual demand in growing and developing economies are both fundamental influences in the world oil market. The most visible signs of these conditions are the transparent market mechanisms that reside in the world today such as NYMEX's futures and options markets, where prices are discovered and risk is managed.

On the supply side, global production of crude oil was relatively flat in 2007 despite rising demand and rising prices which did not provoke a significant supply response. Further, the geopolitical risk provided added uncertainty to supply outlook. Moreover, various state-owned oil companies have not been investing adequately in oil production. Venezuela nationalized assets owned by U.S. oil companies and has generally proved to be an unreliable partner. Mexico's major oil field has been depleted and will not allow U.S. companies to engage in deep water drilling. Colombian rebels have been blowing up pipelines with frequency, and are being financially backed by the Venezuelan Government. Nigerian rebel forces routinely shut down oil fields, either through strikes, terrorism or sabotage.

Russia has suffered a decline in production. And, finally, U.S. production has declined dramatically in the past 20 years, and promising new drilling areas are generally not being opened up due to environmental considerations. The role of speculators in NYMEX markets is widely exaggerated and misunderstood. Our data shows that the percentage of open interest in NYMEX crude oil futures

held by non-commercial participants actually decreased over the last year even at the same time that prices were increasing. The chart that you have on the screen overhead displays the percentage of open interest in the NYMEX crude oil futures contract held by non-commercial longs and shorts relative to that held by commercial longs and shorts.

As you can see, during the last year commercial longs and shorts consistently have comprised between 60 and 70 percent of all open interest. On the other hand, non-commercial longs and shorts consistently have been in the range of 25 to 30 percent of open interest. Therefore, non-commercials holding long or buy positions have not been participating in the market to the extent that they could have a significant impact on market price. Moreover, the extent of non-commercial participation in the crude oil energy futures contract has actually declined since last summer. Additionally, non-commercial participants are not providing disproportionate pressure on the long or buy side of the crude oil futures market. Instead, non-commercials are relatively balanced between buy and sell open positions for NYMEX crude.

It has been widely, yet inaccurately, theorized that speculators can drive up prices. With hundreds of commercial participants and instantaneous price dissemination, any spike in price would be met with an equally strong commercial reaction. If markets move in a direction inconsistent with actual market factors a vast number of participants, including energy producers, wholesalers, and retailers have comparable access to information. These participants will respond to ensure that prices rapidly return to where the industry consensus believes they should be. Speculators do exist, and they play an important role in the market. They add liquidity to the market and enable commercial traders to get in and out of the market when necessary. Speculation traders seek to participate in price trends that are already underway, but because they lack the capacity to make or take delivery, they will never be in a position to hold a market position through delivery. Therefore, they create virtually no impact on daily settlement prices which is the primary benchmark used by the marketplace.

In futures markets, margins function as financial performance bonds and are employed to manage financial risk and to ensure financial integrity. Some have suggested that the answer to high crude oil prices is to impose substantially greater margins on energy futures markets regulated by the CFTC. We believe that this approach is very misguided. Furthermore, given the reality of global competition and energy to revenues, increasing crude oil margins on futures markets regulated by the CFTC invariably will force trading volume away from regulated and transparent U.S. exchanges. Prices in the NYMEX markets are determined by fundamental market forces. However, uncertainty about the availability of supply due to political and security factors, uncertainty about the actual levels of continuing growth and demand in developing parts of the world, and uncertainty about currency fluctuations materially weigh in to the fundamental analysis.

There is no evidence to date that the trading by non-commercials has impaired the price discovery function of the markets nor the

raising margins would have an impact on lowering prices. Thank you, Mr. Chairman.

[The prepared statement of Dr. Newsome follows:]

Testimony of
Dr. James Newsome, President and CEO
New York Mercantile Exchange, Inc.
Before the Subcommittee on General Farm Commodities and Risk Management
United States House of Representatives
May 15, 2008

Mr. Chairman and members of the Committee, my name is Jim Newsome and I am the President and Chief Executive Officer of the New York Mercantile Exchange, Inc. (NYMEX or Exchange). NYMEX is the world's largest forum for trading and clearing physical-commodity based futures contracts, including energy and metals products, and has been in the business for more than 135 years. NYMEX is a federally chartered marketplace, fully regulated by the Commodity Futures Trading Commission (CFTC) both as a "derivatives clearing organization" (DCO) and as a "designated contract market" (DCM). On behalf of the Exchange, its Board of Directors and shareholders, I want to express our appreciation to the Committee for holding today's hearing on recent trading activity in various commodity futures markets. In particular, the Committee is seeking to review the extent to which this activity is generated by market fundamentals or by increased participation by index funds and other institutional investors.

Over the last several years, NYMEX has worked closely with Congressional leaders providing information and other assistance on legislative initiatives that would add greater transparency to unregulated derivatives venues. We believe that these measures reflect a consensus regarding the need for greater transparency and oversight for certain specified products now trading in unregulated over-the-counter electronic trading markets. We look forward to this legislation becoming law in the near future.

We also hope that Congress does not misinterpret the lessons of the recent past by moving to impose new arbitrary and onerous burdens on futures exchanges, which are the most highly regulated and transparent segment of U.S. derivatives markets.

Such steps would shift trading from regulated and transparent markets to unregulated and nontransparent markets and, thus, would constitute a significant step backward in transparency and market integrity. .

OVERVIEW

Prices in our markets are determined by fundamental market forces. However, uncertainty about the availability of supply due to political and security factors, uncertainty about the actual levels of continuing growth of demand in developing parts of the world, and uncertainty about currency fluctuations also materially weigh into the fundamental analysis. NYMEX provides and vigorously monitors a highly regulated and transparent marketplace. The available data indicate that commercials continue to provide the majority of open interest in crude oil futures. Moreover, the extent of non-commercial participation in crude oil has actually declined over the last year. There is no evidence to date either that the trading by non-commercials has impaired the price discovery function of our markets or that raising margins would have an impact on lowering prices.

MARKET ANALYSIS

NYMEX staff monitors the supply and demand fundamentals in the underlying cash market to ensure that NYMEX futures prices generally are consistent with ongoing, cash market price movements and that there are no price distortions. In a highly transparent, regulated and competitive market, prices are affected primarily by fundamental market forces. Currently, uncertainty in the global crude market regarding geopolitical issues, refinery shutdowns and increasing global usage, as well as devaluation of the U.S. dollar, are clearly having an impact on the assessment of market fundamentals. One may view such factors as contributing an uncertainty or risk premium to the usual analysis of supply and demand data. Indeed, such factors now may fairly be viewed as part of the new fundamentals of these commodities.

Before turning to analysis of specific market factors, we note an article that appeared late last week in the Wall Street Journal (WSJ). The WSJ conducted a survey from May 2-6, 2008 of 53 economists. According to that survey, the majority of economists have concluded that "the global surge in food and energy prices is being driven primarily by fundamental market conditions, rather than an investment bubble." "Bubble is not Big Factor in Inflation," May 9, 2008, page A-2. .Fifty-one percent of those respondents said that demand from India and China was the prime factor in soaring energy prices, and 41% said that demand was the chief contributor to rising food costs. Constraint in supply was cited second most often; 20% blamed supply problems for higher food prices, and 15% for increasing energy prices. One economist noted that it was a combination of demand and supply issues.

The demand and supply fundamentals in the oil markets continue to be the driving factors in high oil prices. In the latest Energy Information Administration (EIA) *Short-Term Energy Outlook*, published on May 6, 2008, the demand and supply situation is summarized as follows:

> "The oil supply system continues to operate at near capacity and remains vulnerable to both actual and perceived supply disruptions. The supply and demand balance for the remainder of the year is tighter than in last month's Outlook. World oil markets are particularly tight during the first half of 2008, with year-over-year growth in world oil consumption outstripping growth in non-Organization of the Petroleum Exporting Countries (OPEC) production by over 1 million barrels per day. The combination of rising global demand, fairly normal seasonal inventory patterns, slow gains in non-OPEC supply, and low levels of available surplus production capacity is providing firm support for prices."

I wish to highlight this finding: growth in consumption has outstripped growth in non-OPEC production by over 1 million barrels per day. That is substantially tighter than a snug fit. Indeed, that may be said to be more akin to a choke hold. Conventional wisdom, borne out by substantial experience from overeseas as well as here in North America, is that the short-run worldwide demand for petroleum products such as

gasoline-- especially retail demand-- is highly inelastic: consumption does not decrease by much in the face of significant price rises. With projected demand exceeding supply by 1 million barrels per day, the only way a market with highly inelastic demand will equilibrate is through a substantive rise in price. The upward pressure has been there and, according to these projections, will continue to be there.

DEMAND

At NYMEX, we understand the difficulty of assembling accurate and timely information on non-OECD petroleum consumption and the corresponding challenge in projecting non-OECD consumption. However, the latest EIA *Short-Term Energy Outlook* projections provide important insight into the current state of global demand. EIA projects that world oil demand will grow by 1.2 million barrels per day in 2008, up a healthy 1.4%, with China accounting for 35% of this demand growth. The EIA predicts China's oil consumption will rise by 0.4 million barrels per day in 2008, up 5.6% from its record-high levels achieved in 2007. Almost all of the oil growth in 2008 is projected to come from the non-OECD countries, led by China, India, Middle Eastern countries, and Russia. U.S. oil demand is actually projected to decline slightly by 0.9% in 2008.

As a practical consideration, the most accurate data on energy consumption applies to the U.S., followed by the OECD. However, the strongest source of projected energy demand is from the far-less visible reaches of developing countries such as China, India and the Middle East. While we respect EIA's efforts to project these numbers, we would caution anyone on oversimplifying the challenge of even accurately assessing the demand in these countries, much less projecting it. The only thing we can be certain of is the relentless increase in petroleum demand pushed each year by the millions of people making the transition from less-developed circumstances to the beginnings of middle-class circumstances. Currently, China is putting more than eight

million new cars on the road each year. Does anyone doubt that the average driver is increasing his/her amount of driving each year? India, the Middle East and Russia are experiencing similar transitions. We believe the sheer uncertainty around consumption in these economies, in combination with the extremely tight world market conditions, is a strong influence on price volatility in the world oil market. In concert with the tight market conditions and inelastic demand for petroleum products we highlighted above, that volatility is oscillating around ever increasing prices.

It is key to realize that the market tightness and the market's struggle to discern actual demand in growing and developing economies are both fundamental influences in the world oil market. The most visible signs of these conditions are the transparent market mechanisms that reside in the world today, such as NYMEX's futures and options markets, where prices are discovered and risk is managed. These mechanisms operate immediately. Compare that to fundamental market information, such as the consumption data referred to above. Consumption data, even for the most advanced economies that have been collecting these data and refining the process for collecting these data for decades (by the International Energy Agency), are provided on a preliminary basis six weeks after the fact. The data are then further refined four weeks later and again four weeks after that; all of this for a monthly statistic, which at the time of the final revision is 14 weeks after the month.

When you add onto that process the fact that the most dynamic component of consumption emanates not from those economies but from others where data collection is materially less advanced and the quality of the data much less certain, then the importance of immediate price discovery and transparency becomes even more evident. In a tightly supplied market where demand is highly inelastic, the only check on rising prices is competition and the price transparency and market liquidity that provide the support for it. Anything that reduces price transparency and liquidity under these market

conditions will result in shifting price discovery to the collection of uncoordinated, opaque and, at times, esoteric mechanisms that comprise the cash market that provides limited transparency; a market not informed by the immediate discovery of value but by the relatively untimely release of fundamental information that is of uncertain quality and that provides limited transparency.

SUPPLY

On the supply side, global production of crude oil was relatively flat in 2007, despite rising demand and rising prices. It is important to note that this rising demand did not provoke a significant supply response. The EIA *Short-Term Energy Outlook* points to the slow growth in non-OPEC oil supplies, along with the OPEC quota constraints, which have given "firm support for prices."

Further, the geopolitical risks provide added uncertainty to the oil supply outlook. Moreover, various state-owned oil companies have not been investing adequately in oil production. Venezuela nationalized assets owned by U.S. oil companies and has generally proved to be an unreliable partner. Mexico's major oil field has been depleted, and Mexico will not allow US companies to engage in deep water drilling. Colombian rebels have been blowing up pipelines with some frequency, and are being financially backed by the Venezuelan government. Nigerian rebel forces routinely shut down oil fields - either through strikes, terrorism or sabotage. Russia has suffered a decline in production. Finally, U.S. production has declined dramatically in the past 20 years, and promising new drilling areas are generally not being opened up in this country due to environmental considerations.

In addition, the price for crude in Euros has risen but much more modestly. For instance, the last time the Dollar and Euro were exchanged at par was during December 2002 when the spot price of oil was about $27 per barrel. By the end of April 2008, the

price of oil in Dollars had risen 340% while the price in Euros had risen 180%, a substantial difference. Attached is a chart showing the price of oil in Dollars and Euros since 2000. So, while supply and demand fundamentals are the major determinants of price, at the margin, as the value of the dollar goes down, it may be providing some upward pressure on the price of oil in dollars so that it stays constant in value with the value of crude in Euros.

In the face of these market factors, NYMEX provides a level of economic stability to the market by offering a reliable and well-regulated price discovery and risk management mechanism. Our highly transparent, open and competitive market continues to work according to design.

NYMEX'S ROLE

Futures markets fulfill two primary functions that provide important economic benefits to the public: (1) permitting hedging, giving market participants the ability to shift price risk to others who have inverse risk profiles or who are willing to assume that risk for profit; and (2) facilitating price discovery and market transparency. Transparency involves many factors, including: (1) continuous price reporting during the trading session that is disseminated on a real-time basis worldwide by various market data vendors; (2) daily reporting of trading volume and open interest; and (3) monthly reporting of deliveries against the futures contract.

NYMEX is the benchmark for energy prices around the world. Trading on NYMEX is transparent, open and competitive and highly regulated. NYMEX does not trade in the market or otherwise hold any market positions in any of its listed contracts, and, being price neutral, does not influence price movement or set prices for commodities trading on the exchange. Instead, NYMEX provides trading forums that are structured as pure auction markets for traders to come together and to execute trades at competitively determined prices that best reflect what market participants think prices

will be in the future, given today's information. Further, NYMEX operates in the most highly regulated trading tier overseen by the CFTC. As such, NYMEX maintains rigorous oversight and enforcement programs designed to promote the orderly operation of its markets and to detect and to deter any ill activity which would negatively effect the market and its users.

Futures markets provide a reference point for use in executing off-exchange trades at competitively determined prices. In addition, there is a strong beneficial and interdependent relationship between the futures and the underlying physical commodity or "cash" markets. The primary motivation for using the futures market is to hedge against price risk in the cash market. Price volatility drives many into the futures markets to offset the risk. Prudent business managers rely on the futures market to protect their business against price swings in the cash market.

ANALYSIS OF PARTICIPATION IN NYMEX CRUDE OIL CONTRACT

Data analysis conducted by our Research Department indicates that the percentage of open interest in NYMEX Crude Oil futures held by non-commercial participants relative to commercial participants actually decreased over the last year even at the same time that prices were increasing. The attached chart indicates the percentage of open interest in the NYMEX Crude Oil futures contract held by non-commercial longs and shorts relative to that held by commercial longs and shorts. The review period commenced at the beginning of 2006 and continues through to the present. As can be seen, during the last year, commercial longs and shorts consistently have comprised between 60 and 70% of all open interest.

On the other hand, non-commercial longs and shorts consistently have been in the range of 25-30% of the open interest Thus, non-commercials holding long or buy positions have not been participating in the market to the extent that they could have a significant impact on market price. Moreover, as noted, the extent of non-commercial

participation in the crude oil energy futures contract has actually declined since the levels observed last summer. It should also be noted that the percentage of non-commercials longs (as a percentage of all long or buy open positions) is generally within just a few percentage points of the percentage of non-commercials shorts (as a percentage of all short or sell positions). In other words, non-commercial participants are not providing disproportionate pressure on the long or buy side of the crude oil futures market. Instead, non-commercials are relatively balanced between buy and sell open positions for NYMEX crude oil futures. In addition, "hedge funds" identified in analysis conducted by NYMEX staff only accounted for approximately 5% of the total volume in the NYMEX Light Sweet Crude Oil contract in 2007.

According to the CFTC website, for purposes of their Commitment of Traders Reports, commercials and non-commercials are categorized as follows:

> **"Commercial and Non-commercial Traders**. When an individual reportable trader is identified to the Commission, the trader is classified either as "commercial" or "non-commercial." All of a trader's reported futures positions in a commodity are classified as commercial if the trader uses futures contracts in that particular commodity for hedging as defined in CFTC Regulation 1.3(z); 17 CFR 1.3(z). A trading entity generally gets classified as a "commercial" trader by filing a statement with the Commission, on CFTC Form 40: Statement of Reporting Trader, that it is commercially "...engaged in business activities hedged by the use of the futures or option markets." To ensure that traders are classified with accuracy and consistency, Commission staff may exercise judgment in re-classifying a trader if it has additional information about the trader's use of the markets.
>
> A trader may be classified as a commercial trader in some commodities and as a non-commercial trader in other commodities. A single trading entity cannot be classified as both a commercial and non-commercial trader in the same commodity. Nonetheless, a multi-functional organization that has more than one trading entity may have each trading entity classified separately in a commodity. For example, a financial organization trading in financial futures may have a banking entity whose positions are classified as commercial and have a separate money-management entity whose positions are classified as non-commercial."

Currently, NYMEX's core energy futures contracts trade on the Exchange floor and by electronic trade-matching on CME Globex®. For energy contracts, trading

terminates in the month preceding the month of actual delivery of the underlying commodity (if positions are not offset and held through the termination of trading for that contract month). Consequently, the front or spot month listed for much of this month has been the June 2008 contract month. The daily settlement price for each contract month of a listed contract is calculated pursuant to Exchange rules, which reflect the various business judgments exercised by Exchange officials in the calculation of our settlement prices.

By listing contracts that are traded in contract months listed out into the future, our prices at all times are reflective of the collective consensus of the marketplace as to the future direction of commodity prices. By contrast, many cash markets of the underlying commodities for our products, such as for gasoline, are quoted and traded in the cash market for near-term, prompt delivery (sometimes next-day). Consequently, there can be at times significant differences between prices in our markets and prices in the prompt-delivery cash market.

NYMEX energy futures markets are highly liquid and transparent, representing the views and expectations of a wide variety of participants from every sector of the energy marketplace. Customers from jurisdictions around the globe can submit orders for execution on Globex. The price agreed upon for sale of any futures contract trade is immediately transmitted to the Exchange's electronic price reporting system and to the news wires and information vendors who inform the world of accurate futures prices.

Price signals are the most efficient transmitters of economic information, telling us when supplies are short or in surplus, when demand is robust or wanting, or when we should take notice of longer-term trends. NYMEX futures markets are the messengers carrying this information from the energy industry to the public. The wide dissemination of futures prices generates competition in the establishment of current cash values for commodities.

SURVEILLANCE

NYMEX has numerous surveillance tools, which are used routinely to ensure fair and orderly trading on our markets. The NYMEX Market Surveillance staff routinely reviews price activity in both futures and cash markets, focusing on whether the futures markets are converging with the spot physical market as the NYMEX contract nears expiration. Large trader data are reviewed daily to monitor reportable positions in the market. On a daily basis NYMEX collects the identities of all participants who maintain open positions that exceed set reporting levels as of the close of business the prior day. Generally NYMEX identifies in excess of 85% of all open positions through this process. These data, among other things, are used to identify position concentrations requiring further review and focus by Exchange staff. Any questionable market activity results in an inquiry or formal investigation. By rule, NYMEX also maintains and enforces limits on the size of positions that any one market participant may hold in a listed contract. These limits are set at a level that greatly restricts the opportunity to engage in possible manipulative activity on our markets.

NYMEX maintains a comprehensive audit trail of all transactions executed on the Exchange. The audit trail includes such data as trade time, executing broker or trader, and the account number for the beneficial owner of the trade and other data, which can be used to reconstruct trading activity for investigative purposes.

SPECULATORS

It is widely, yet inaccurately, theorized that speculators can drive prices up. Placing blame on speculators may grab the attention of the media, but does not accurately reflect the realities of how markets work. With hundreds of commercial participants and instantaneous price dissemination, any "speculative" price would be expected to be met with an equally strong "commercial" reaction. If markets move in a direction inconsistent with actual market factors, a vast number of participants, including

energy producers, wholesalers, retailers, and government agencies, have comparable access to information. These participants will respond to ensure that prices rapidly return to where the industry consensus believes they should be.

Speculators do exist and, while it may not be politically popular to acknowledge this reality, the simple truth is that they play a necessary role in the market. They add liquidity to the market and enable commercial traders to get in and out of the market when necessary. By the nature of their role, speculative traders seek to participate in price trends that are already underway, but because they lack the capacity to make or take delivery, they will never be in a position to hold a market position through to the delivery process. They create virtually no impact on daily settlement prices, the primary benchmark used by the marketplace.

MARGINS

In futures markets, margins function as financial performance bonds and are employed to manage financial risk and to ensure financial integrity. A futures margin deposit has the economic function of ensuring the smooth and efficient functioning of futures markets and the financial integrity of transactions cleared by a futures clearinghouse. Margin levels are routinely adjusted in response to market volatility. At NYMEX, margin generally is collected to cover a 99 percent probability of a likely one-day price move, based on an analysis of historical and implied data.

Some have suggested that the answer to higher crude oil prices is to impose substantially greater margins on energy futures markets regulated by the CFTC. We believe that this approach is misguided. As previously noted, in a highly transparent, regulated and competitive market, prices are affected primarily by fundamental market forces and imposing more onerous margin levels will not affect price levels. Currently, uncertainty in the global crude market regarding geopolitical issues, refinery shutdowns and increasing global usage, as well as devaluation of the U.S. dollar, are now market

fundamentals. Adjusting margin levels significantly upward will not change the underlying market fundamentals. Furthermore, given the reality of global competition in energy derivatives, increasing crude oil margins on futures markets regulated by the CFTC inevitably will force trading volume away from regulated and transparent U.S. exchanges into the unlit corners of unregulated venues and onto less regulated and more opaque overseas markets.

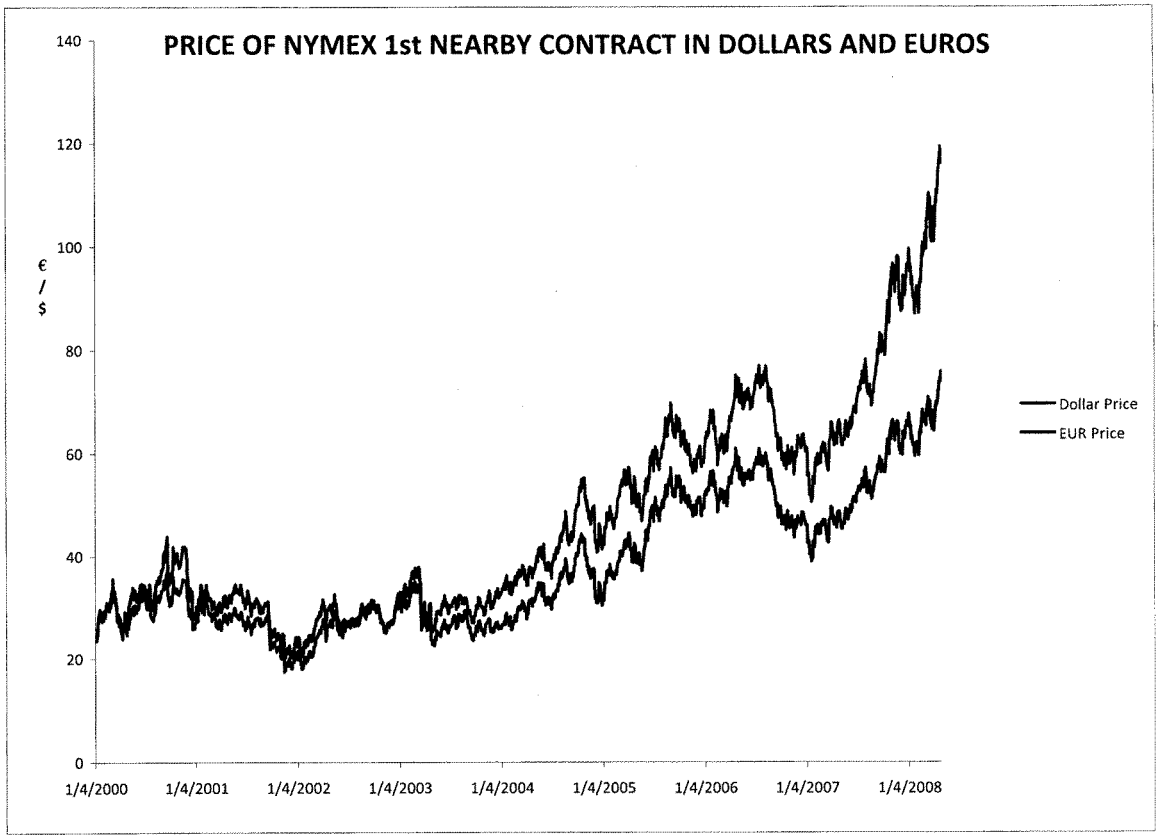
Finally, Exchange staff has examined trends in margin levels at the Exchange going back to early 2000. The data clearly indicate that higher margin levels lead rather than follow increases in the price of crude oil futures products. In other words, when Exchange staff, in exercising their independent and neutral business judgment, determined to increase margin levels in response to changes in crude oil volatility levels, the higher margin levels were followed not by lower prices but instead by yet higher crude prices.

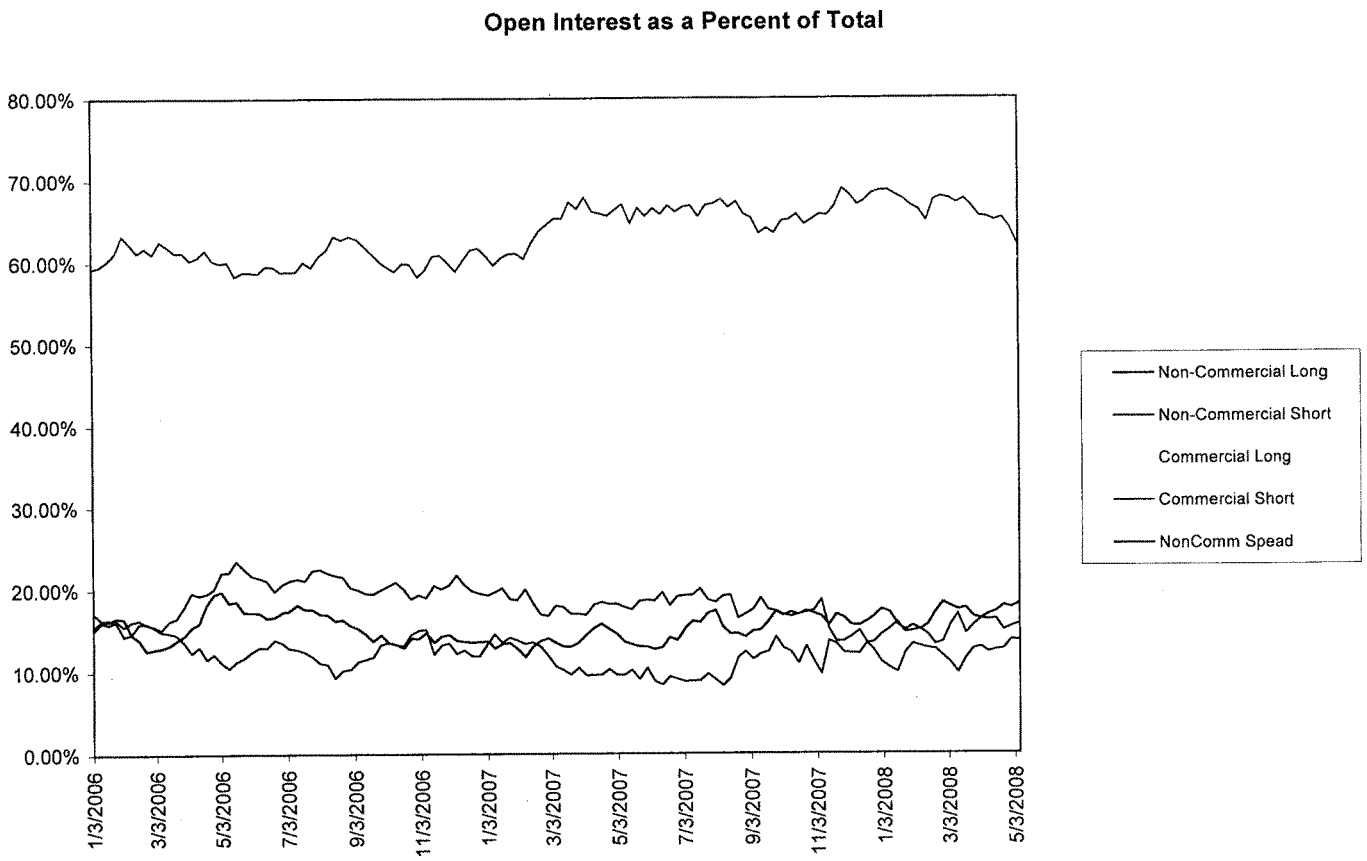
CONCLUSION

At all times during periods of volatility in the market, NYMEX has been the source for transparent prices in the energy markets as well as the principal vehicle by which market participants achieve stability. Remember, futures markets provide the means by which to achieve price certainty and lock-in prices. Our price reporting systems, which provide information to the world's vendors, have worked flawlessly and without delay. The NYMEX marketplace continues to perform its responsibility to provide regulated forums that ensure open, competitive and transparent energy pricing. The market uncertainty and mayhem and further devastation to consumers that would unfold is clear if NYMEX were unable to perform its duty and prices were determined, subject to limited competition, behind closed doors. Policies that would inevitably result in reducing transparency and liquidity would only succeed in conferring market power unto those who would benefit from price increases in the crude oil market, a market that is so

prominently characterized by the inflexible demand of its end-users. Transparency and liquidity are the foundation that supports competition in the oil market.

I thank you for the opportunity to share the viewpoint of the New York Mercantile Exchange with you today. I will be happy to answer any questions that any Members of the Committee may have.


PRICE OF NYMEX 1st NEARBY CONTRACT IN DOLLARS AND EUROS
€ / $
140
120
100
80
60
40
20
0
1/4/2000
1/4/2001
1/4/2002
1/4/2003
1/4/2004
1/4/2005
1/4/2006
1/4/2007
1/4/2008
Dollar Price
EUR Price


Open Interest as a Percent of Total
80.00%
70.00%
60.00%
50.00%
40.00%
30.00%
20.00%
10.00%
0.00%
1/3/2006
3/3/2006
5/3/2006
7/3/2006
9/3/2006
11/3/2006
1/3/2007
3/3/2007
5/3/2007
7/3/2007
9/3/2007
11/3/2007
1/3/2008
3/3/2008
5/3/2008
Non-Commercial Long
Non-Commercial Short
Commercial Long
Commercial Short
NonComm Spead

The CHAIRMAN. I thank the gentleman. We are going to have to recess until we get through voting. I thought we would get everybody in, but the clock has run out on us. It will be about 30 minutes. If you want to just stretch a little bit, we will be back.

[Recess.]

The CHAIRMAN. Begin your testimony, please, ma'am, 5 minutes. Four minutes would be better.

STATEMENT OF LAURA CAMPBELL, ASSISTANT MANAGER OF ENERGY RESOURCES, MEMPHIS LIGHT, GAS & WATER, MEMPHIS, TN; ON BEHALF OF AMERICAN PUBLIC GAS ASSOCIATION

Ms. CAMPBELL. Fair enough. Chairman Etheridge, Members of the Subcommittee, I appreciate this opportunity to testify before you today, and I thank the Subcommittee for calling this hearing on the important subject of trading activities. My name is Laura Campbell, and I am the Assistant Manager of Energy Resources from Memphis Light, Gas & Water. MLGW is the nation's largest three service municipal utility. I testify today on behalf of the American Public Gas Association or APGA. APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states, and almost 700 of these systems are APGA members.

Publicly-owned gas systems are not-for-profit retail distribution entities owned by and accountable to the citizens they serve. APGA's number one priority is the safe and reliable delivery of affordable natural gas. To bring natural gas prices back to long-term affordable level, we ultimately need to increase the supply of natural gas. However, equally critical is to restore public confidence in the pricing of natural gas. This requires a level of transparency in natural gas markets which assures consumers that market prices are a result of fundamental supply and demand forces and not the result of manipulation or other abusive market conduct. APGA believes that the increased regulatory reporting and self-regulatory provisions relating to the unregulated energy trading platforms contained in legislation that reauthorizes the Commodity Futures Trading Commission is a critically important step in addressing our concerns. Those provisions are contained in Title XIII of the farm bill, which was passed yesterday by the House of Representatives.

We commend this Committee for its work on the CFTC reauthorization bill. We also believe that under Acting Chairman Lukken's leadership the CFTC has taken important first steps in addressing our concerns by forming an Energy Markets Advisory Committee. We, along with other consumer groups, have watched with alarm certain pricing anomalies in the markets for natural gas. More recently, we have noted a run-up in the price of energy and other physical commodities. One of the topics of today's hearing is whether the price behavior reflects market fundamentals or results from other factors in the market, such as a change in the level or nature of speculative trading in the market. We simply do not know the answer to that question.

As hedgers, we depend on liquid and deep markets in which to lay off our risks. Speculators are the grease that provides the li-

quidity and depth to the markets, and we value the role that they play in the markets. However, some trading strategies such as those pursued by Amaranth Advisors have had an adverse effect on the price of natural gas. We believe that in order to restore confidence in the pricing of these energy markets and in order to answer the questions raised by this Committee with respect to the effect of speculative trading interests in the current environment a greater level of market transparency is needed. In response to the failures that Amaranth's market abuse has brought to light, APGA over the last several years has pushed for a level of market transparency in financial contracts in natural gas that would routinely and perspectively permit the CFTC to assemble a complete picture of the overall size and potential impact of a trader's positions, irrespective of whether the positions are entered into on the NYMEX, on an OTC multi-lateral electronic trading facility, which is exempt from regulation, or through bilateral OTC contracts.

APGA is optimistic that the enhanced authorities provided to the CFTC and the provisions of the CFTC reauthorization bill will help address the concerns that we have raised. Nonetheless, APGA also supports proposals to further increase and enhance transparency in the energy markets. APGA urges the CFTC to take additional steps to increase transparency within its existing authorities. For example, the CFTC in 2007 made certain enhancements to the commitment of traders reports by reporting separately the aggregate positions held by long-only, passively managed investment funds. To the extent that such funds hold positions in energy commodities, APGA encourages the CFTC to reconsider expanding those enhancements to the commitment of traders reports to include energy commodities.

The CFTC plays a critical role in protecting consumers and the market as a whole from fraud and manipulation. APGA encourages Congress to provide sufficient funding for the CFTC to effectively carry out its oversight responsibilities. Natural gas is the life blood of our economy and millions of consumers depend on natural gas every day to meet their daily needs. It is critical that the price those consumers are paying for natural gas comes about through the operation of fair and orderly markets. It is too soon to determine whether the provisions of the farm bill will fully achieve the goals of increasing transparency with respect to pricing and natural gas markets.

In light of the critical importance of this issue to consumers, we believe that the Committee should maintain active and vigilant oversight of the CFTC's market surveillance and enforcement activities, and APGA and its approximately 700 public gas system members applaud your efforts to do so. We look forward to working with the Committee to determine whether further enhancements are necessary to restore consumer confidence and the integrity of price discovery mechanisms.

[The prepared statement of Ms. Campbell follows:]

TESTIMONY OF LAURA CAMPBELL

ASSISTANT MANAGER OF ENERGY RESOURCES,

MEMPHIS LIGHT, GAS & WATER

ON BEHALF OF THE AMERICAN PUBLIC GAS ASSOCIATION

BEFORE THE HOUSE AGRICULTURE SUBCOMMITTEE ON GENERAL

FARM COMMODITIES AND RISK MANAGEMENT

MAY 15, 2008

Chairman Etheridge, Ranking Member Moran and Members of the Subcommittee, I appreciate this opportunity to testify before you today and I thank the Subcommittee for calling this hearing on the important subject of trading activity in various commodity futures markets, whether the role in the markets of certain types of speculative trading activity is changing, and possible effects on the markets from that activity. My name is Laura Campbell and I am the Assistant Manager of Energy Resources for Memphis Light Gas & Water (MLGW). MLGW is the nation's largest three-service municipal utility and currently provides service to more than 420,000 customers. Since 1939, MLGW has met the utility needs of Memphis, Tennessee and Shelby County residents by delivering reliable and affordable electricity, natural gas and water service. Natural gas is the most popular means of residential heating in the MLGW service area and we currently provide natural gas to more than 313,000 customers.

I testify today on behalf of the American Public Gas Association (APGA). APGA is the national association for publicly-owned natural gas distribution systems. There are

approximately 1,000 public gas systems in 36 states and almost 700 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities.

APGA's number one priority is the safe and reliable delivery of affordable natural gas. To bring natural gas prices back to a long-term affordable level, we ultimately need to increase the supply of natural gas. However, equally critical is to restore public confidence in the pricing of natural gas. This requires a level of transparency in natural gas markets which assures consumers that market prices are a result of fundamental supply and demand forces and not the result of manipulation or other abusive market conduct.

We, along with other consumer groups, have watched with alarm over the last several years certain pricing anomalies in the markets for natural gas. More recently, we have noted a run-up in the price of energy and other physical commodities. One of the topics of today's hearing is whether this price behavior reflects market fundamentals or results from other factors in the market, such as a change in the level or nature of speculative trading in the market. We do not know the answer to that question. However, APGA strongly believes that a higher level of transparency with respect to trading activity in these markets than currently exists is needed in order to restore our current lack of

confidence in the natural gas marketplace and to enable the CFTC, and market users, to form a reasoned response to this critically important question.

APGA believes that the increased regulatory, reporting and self-regulatory provisions relating to the unregulated energy trading platforms contained in legislation that reauthorizes the Commodity Futures Trading Commission ("CFTC") is a critically important step in addressing our concerns. Those provisions are contained in Title XIII of the Farm Bill, which is currently being considered by the Congress. We commend this Committee for its work on the CFTC reauthorization bill and support its passage by the Congress.

We also believe that under Acting Chairman Lukken's leadership the CFTC has taken important first steps in addressing our concerns by forming an Energy Markets Advisory Committee to provide a public forum to examine emerging issues related to the energy markets and the CFTC's role in these markets under the Commodity Exchange Act. The first meeting is scheduled for June 10, 2008.

APGA believes that the additional authorities which will be provided to the CFTC under the reauthorization bill may provide the CFTC with the additional tools to answer the questions raised by this hearing, at least with respect to the energy markets. We also believe, however, in light of the critical importance of this issue to consumers, that this Committee should maintain active and vigilant oversight of the CFTC's market surveillance and enforcement efforts.

Speculators' Effect on the Natural Gas Market

As consumers that make use of the futures and the over-the-counter ("OTC") energy markets for hedging purposes, we value the role of speculators in the markets. As hedgers, we depend upon liquid and deep markets in which to lay off our risk. Speculators are the grease that provides liquidity and depth to the markets. However, speculative trading strategies may not always have a benign effect on the markets. For example, the recent blow-up of Amaranth Advisors LLC and the impact it had upon prices exemplifies the impact that speculative trading interests can have on natural gas supply contracts for local distribution companies ("LDCs").

Amaranth Advisors LLC was a hedge fund based in Greenwich, Connecticut, with over $9.2 billion under management. Although Amaranth classified itself as a diversified multi-strategy fund, the majority of its market exposure and risk was held by a single Amaranth trader in the OTC derivatives market for natural gas.

Amaranth reportedly accumulated excessively large long positions and complex spread strategies far into the future. Amaranth's speculative trading wagered that the relative relationship in the price of natural gas between summer and winter months would change as a result of shortages which might develop in the future and a limited amount of storage capacity. Because natural gas cannot be readily transported about the globe to offset local shortages, the way for example oil can be, the market for natural gas is particularly susceptible to localized supply and demand imbalances. Amaranth's strategy was

reportedly based upon a presumption that hurricanes during the summer of 2006 would make natural gas more expensive in 2007, similar to the impact that hurricanes Katrina and Rita had had on prices the previous year. As reported in the press, Amaranth held open positions to buy or sell tens of billions of dollars of natural gas.

As the hurricane season proceeded with very little activity, the price of natural gas declined, and Amaranth lost approximately $6 billion, most of it during a single week in September 2006. The unwinding of these excessively large positions and that of another previously failed $430 million hedge fund—MotherRock— further contributed to the extreme volatility in the price of natural gas. The Report by the Senate Permanent Subcommittee on Investigations affirmed that "Amaranth's massive trading distorted natural gas prices and increased price volatility."[1]

Many natural gas distributors locked-in prices prior to the period Amaranth collapsed at prices that were elevated due to the accumulation of Amaranth's positions. They did so because of their hedging procedures which require that they hedge part of their winter natural gas in the spring and summer. Accordingly, even though natural gas prices were high at that time, it would have been irresponsible (and contrary to their hedging policies) to not hedge a portion of their winter gas in the hope that prices would eventually drop. Thus, the elevated prices which were a result of the excess speculation in the market by Amaranth and others had a significant impact on the price these APGA members, and ultimately their customers, paid for natural gas. The lack of transparency with respect to

[1] *See "Excessive Speculation in the Natural Gas Market,"* Report of the U.S. Senate Permanent Subcommittee on Investigations (June 25, 2007) ("PSI Report") at p. 119

this trading activity, much of which took place in the OTC markets, and the extreme price swings surrounding the collapse of Amaranth have caused bona fide hedgers to become reluctant to participate in the markets for fear of locking-in prices that may be artificial.

We believe that in order to restore confidence in the pricing of these energy markets, and in order to answer the questions raised by this Committee with respect to the effect of speculative trading interests in the current environment, a greater level of market transparency is needed.

The Market in Natural Gas Contracts

The market for natural gas financial contracts is composed of a number of segments. Contracts for the future delivery of natural gas are traded on NYMEX, a designated contract market regulated by the CFTC. Contracts for natural gas are also traded in the OTC markets. OTC contracts may be traded on multi-lateral electronic trading facilities which are exempt from regulation as exchanges. They may also be traded in direct, bi-lateral transactions between counterparties, through voice brokers or on electronic platforms. OTC contracts may be settled financially or through physical delivery. Financially-settled OTC contracts often are settled based upon NYMEX settlement prices and physically delivered OTC contracts may draw upon the same deliverable supplies as NYMEX contracts, thus linking the various financial natural gas market segments economically.

Increasingly, the price of natural gas in many supply contracts between suppliers and local distribution companies, including APGA members, is determined based upon monthly price indexes closely tied to the monthly settlement of the NYMEX futures contract. Accordingly, the futures market serves as the centralized price discovery mechanism used in pricing these natural gas supply contracts.

Generally, futures markets are recognized as providing an efficient and transparent means for discovering commodity prices.[2] However, any failure of the futures price to reflect fundamental supply and demand conditions, such as the effect of Amaranth's trading in the markets, results in prices for natural gas that are distorted and which do not reflect its true value.[3] This has a direct affect on consumers all over the U.S., who as a result of such price distortions, will not pay a price for the natural gas that reflects bona fide demand and supply conditions. If the futures price is manipulated or distorted, then the price a consumer pays for the fuel needed to heat their home and cook their meals will be similarly manipulated or distorted.

Today, the CFTC has effective oversight of futures exchanges, and the CFTC and the exchanges provide a significant level of transparency. But, the OTC markets lack such price transparency. This lack of transparency in a very large and rapidly growing segment of the natural gas market leaves open the potential for a participant to engage in

---

[2] *See* the Congressional findings in Section 3 of the Commodity Exchange Act, 7 U.S.C. §1 et seq. ("Act"). Section 3 of the Act provides that, "The transactions that are subject to this Act are entered into regularly in interstate and international commerce and are affected with a national public interest by providing a means for . . . discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities."

[3] *See generally PSI Report.* The PSI Report on page 3 concluded that "Traders use the natural gas contract on NYMEX, called a futures contract, in the same way they use the natural gas contract on ICE, called a swap. . . . The data show that prices on one exchange affect the prices on the other."

manipulative or other abusive trading strategies with little risk of early detection; and for problems of potential market congestion to go undetected by the CFTC until after the damage has been done to the market.

Regulatory Oversight

NYMEX, as a designated contract market, is subject to oversight by the CFTC. The primary tool used by the CFTC to detect and deter possible manipulative activity in the regulated futures markets is its large trader reporting system. Using that regulatory framework, the CFTC collects information regarding the positions of large traders who buy, sell or clear natural gas contracts on NYMEX. The CFTC in turn makes available to the public aggregate information concerning the size of the market, the number of reportable positions, the composition of traders (commercial/non-commercial) and their concentration in the market, including the percentage of the total positions held by each category of trader (commercial/non-commercial).

The CFTC also relies on the information from its large trader reporting system in its surveillance of the NYMEX market. In conducting surveillance of the NYMEX natural gas market, the CFTC considers whether the size of positions held by the largest contract purchasers are greater than deliverable supplies not already owned by the trader, the likelihood of long traders demanding delivery, the extent to which contract sellers are able to make delivery, whether the futures price is reflective of the cash market value of the commodity and whether the relationship between the expiring future and the next

delivery month is reflective of the underlying supply and demand conditions in the cash market.[4]

Although the CFTC has issued "special calls" to one electronic trading platform, and that platform has determined to voluntarily provide the CFTC with information on traders' large positions,[5] the CFTC's large trader reporting surveillance system does not routinely reach traders' large OTC positions.[6] Despite the links between prices for the NYMEX futures contract and the OTC markets in natural gas contracts, this lack of transparency in a very large and rapidly growing segment of the natural gas market leaves open the potential for participants to engage in manipulative or other abusive trading strategies with little risk of early detection and for problems of potential market congestion to go undetected by the CFTC until after the damage has been done to the market, ultimately costing the consumers or producers of natural gas.

Greater Transparency Needed

Our members, and the customers served by them, do not believe there is an adequate level of market transparency under the current system. This lack of transparency has led to a growing lack of confidence in the natural gas marketplace. Although the CFTC operates a large trader reporting system to enable it to conduct surveillance of the futures markets, it cannot effectively monitor trading if it receives information concerning

---

[4] *See* letter to the Honorable Jeff Bingaman from the Honorable Reuben Jeffery III, dated February 22, 2007.

[5] *Id*, at 7. The CFTC presumably issued this call for information under Section 2(h)(5) of the Act.

[6] Special calls are generally considered to be extraordinary, rather than routine, requirements. Although special calls may be an important complement to routine reporting requirements in conducting market surveillance, they are not a substitute for a comprehensive large trader reporting system.

positions taken in only one segment of the total market. Without comprehensive large trader position reporting, the government is currently handicapped in its ability to detect and deter market misconduct. If a large trader acting alone, or in concert with others, amasses a position in excess of deliverable supplies and demands delivery on its position and/or is in a position to control a high percentage of the deliverable supplies, the potential for market congestion and price manipulation exists.

Over the last several years, APGA has pushed for a level of market transparency in financial contracts in natural gas that would routinely, and prospectively, permit the CFTC to assemble a complete picture of the overall size and potential impact of a trader's position irrespective of whether the positions are entered into on NYMEX, on an OTC multi-lateral electronic trading facility which is exempt from regulation or through bi-lateral OTC transactions, which can be conducted over the telephone, through voice-brokers or via electronic platforms. APGA is optimistic that the enhanced authorities provided to the CFTC in the provisions of the CFTC reauthorization bill will help address the concerns that we have raised.

Additional potential enhancements in transparency

In supporting the CFTC reauthorization bill, we previously noted that only a comprehensive large trader reporting system would enable the CFTC, while a scheme is unfolding, to determine whether a trader, such as Amaranth, is using the OTC natural gas

markets to corner deliverable supplies and manipulate the price in the futures market.[7] A comprehensive large trader reporting system would also enable the CFTC to better detect and deter other types of market abuses, including for example, a company making misleading statements to the public or providing false price reporting information designed to advantage its natural gas trading positions, or a company engaging in wash trading by taking large offsetting positions with the intent to send misleading signals of supply or demand to the market. Such activities are more likely to be detected or deterred when the government is receiving information with respect to a large trader's overall positions, and not just those taken in the regulated futures market.

Accordingly, APGA supports proposals to increase and enhance transparency in the energy markets, generally, and in the markets for natural gas, specifically. However, APGA also notes that there are additional steps to increase transparency that the CFTC should consider taking within its existing authorities.[8] The CFTC in 2007 made certain enhancements to its Commitment of Traders Reports by reporting separately the aggregate positions held by long-only, passively managed investment funds. To the extent that such funds hold positions in energy commodities, APGA encourages the CFTC to consider expanding these enhancements to their Commitment of Traders Reports to include energy commodities. Enhanced transparency with respect to the participants in the markets and their aggregate position in the markets will improve our

[7] *See e.g. U.S. Commodity Futures Trading Commission* v. *BP Products North America, Inc.*, Civil Action No. 06C 3503 (N.D. Ill.) filed June 28, 2006.

[8] For example, the CFTC recently amended its Rule 18.05 "special call" provision to make explicit that its special call authority to traders applies to OTC positions, including bi-lateral transactions and transactions executed on the unregulated electronic trading facilities where the trader has a reportable position on a designated contract market in the same commodity. This amendment made explicit authority that the CFTC has previously exercised under Rule 18.05 to require a trader with a reportable position on a regulated exchange, upon special call, to report related OTC positions.

understanding of the dynamics of the market at any particular time, potentially increasing hedger's confidence in the markets' price discovery function.

CFTC Resources

The CFTC plays a critical role in protecting consumers, and the market as a whole, from fraud and manipulation. It is essential that the CFTC have the necessary resources to monitor markets and protect consumers from attempts to manipulate the market. This is essential given the additional oversight responsibilities the CFTC will have through the market transparency language included in the Farm Bill. Over the last several years, trading volumes have doubled while CFTC staffing levels have, on average, decreased. In fact, while we are experiencing record trading volumes, employee levels at the CFTC are at their lowest since the agency was created. APGA is concerned that if funding for the CFTC is inadequate, so may be the level of protection.

Conclusion

Our testimony today is not meant to imply that the CFTC has not been vigilant in pursuing wrongdoers. Experience tells us that there is never a shortage of individuals or interests who believe they can, and will attempt to, affect the market or manipulate price movements to favor their market position. The fact that the CFTC has assessed over $300 million in penalties, and has assessed over $2 billion overall in government settlements relating to abuse of these markets affirms this. These efforts to punish those

that manipulate or otherwise abuse markets are important. But it must be borne in mind that catching and punishing those that manipulate markets after a manipulation has occurred is not an indication that the system is working. To the contrary, by the time these cases are discovered using the tools currently available to government regulators, our members, and their customers, have already suffered the consequences of those abuses in terms of higher natural gas prices. Similarly, because of the current lack of transparency in the natural gas markets, we, the regulators, and the self-regulatory organizations, are not in a position to answer definitively whether prices in the natural gas markets today are truly reflective of market fundamentals or are responding, in part, to certain speculative trading strategies and traders. Greater transparency with respect to traders' large positions, whether entered into on a regulated exchange or in the OTC markets in natural gas will provide the CFTC with the tools to answer that question and to detect and deter potential manipulative activity before our members and their customers suffer harm.

This hearing has raised issues that are vital to APGA's members and their customers. We do not yet have the tools in place to say with confidence whether the pricing mechanisms in the natural gas market today are reflecting market fundamentals or the possible market effects of various speculative trading strategies. However, we know that the confidence that our members once had in the pricing integrity of the markets has been badly shaken.

Natural gas is a lifeblood of our economy and millions of consumers depend on natural gas every day to meet their daily needs. It is critical that the price those consumers are

paying for natural gas comes about through the operation of fair and orderly markets and through appropriate market mechanisms that establish a fair and transparent marketplace. It is too soon to determine whether the provisions of the Farm Bill, if enacted, will fully achieve the goals of increasing transparency with respect to the pricing in the natural gas markets. These goals will be met if the proposed amendments enable the CFTC to (1) detect a problem before harm has been done to the public through market manipulation or price distortions; (2) protect the public interest; and (3) ensure the price integrity of the markets. Accordingly, APGA and its approximately 700 public gas system members applaud your continued oversight of the CFTC's surveillance of the natural gas markets. We look forward to working with the Committee to determine whether further enhancements are necessary to restore consumer confidence in the integrity of the price discovery mechanism.

The CHAIRMAN. Thank you, Ms. Campbell. I will now recognize each Member for 5 minutes for questions in the order in which they appeared. I will now recognize myself for 5 minutes. Mr. Ramm, you indicated that you wanted to raise the margin requirements for non-commercial entities. Legislation introduced in the Senate, called the Consumer-First Energy Act of 2008, could raise margin requirements for everyone. What do you think of their proposal, and how would this impact your company's ability to use these markets for hedge purposes?

Mr. RAMM. Well, I think in my testimony I stated that there would be a non-commercial raising so it would be only in the non-physical speculator, and I don't think——

The CHAIRMAN. But my point is the Senate bill would raise it for everyone.

Mr. RAMM. Yes, and we don't support that.

The CHAIRMAN. Okay. That was my question. Dr. Newsome, your testimony states that the crude oil market has been declining in non-commercial participation over the last year. I believe that is what I read. The GAO study on energy derivatives cited by Mr. Ramm also makes that point that non-commercial participation in crude oil has declined. How do we square these facts with the facts that crude oil prices have increased and claims that speculators are behind it all?

Dr. NEWSOME. Mr. Chairman, to me it is a clear indication that speculators are not behind the rise in crude oil prices or potentially the other commodities. I think devaluation of the dollar, the supply-demand fundamentals that we talked about earlier are the clear drivers behind the increase in these commodity prices.

The CHAIRMAN. Mr. Ramm, you mentioned in your testimony the issue regarding the five percent tax credit on ethanol that is used in blending gasoline and that with some companies it is a splash blend, others it is injection. And without naming the companies, which I may eventually, we have at least one, now two, talking about already moving to injection so, number one, they can use a lower grade to raise the level of the octane with the ethanol, which means you as the distributor do not get that portion of the credit, so they retain it. Is that what you were saying?

Mr. RAMM. That is correct, sir.

The CHAIRMAN. So does that mean if the major company is retaining it and they have stores or stations of their own, you are at a five percent competitive disadvantage to begin with?

Mr. RAMM. That would be correct.

The CHAIRMAN. I am not sure that was the intent of the legislation.

Mr. RAMM. I would agree.

The CHAIRMAN. This is not the Committee of jurisdiction, but it certainly seems to me that somebody is—I reckon the oil companies probably are figuring they aren't making enough money.

Mr. RAMM. The practice that we are seeing is that as terminals put in the injection equipment, the major companies are not allowing us as marketers to splash blend anymore. We are not seeing a corresponding price of the credit on the product that we are now having to buy after it has been injected.

The CHAIRMAN. So that means that you are at a five percent disadvantage starting off?

Mr. RAMM. Yes, sir.

The CHAIRMAN. Would you share with the Committee what "splash blending" is for people that don't know what "splash blending" is?

Mr. RAMM. "Splash blending' would be where a marketer purchases his own ethanol, buys his product, and then puts the ethanol, the 10 percent blend of ethanol, into the fuel before delivery.

The CHAIRMAN. So what advantage—why would you want to do that?

Mr. RAMM. Based on that type of action then the marketer can apply for the credit.

The CHAIRMAN. And it flows to the marketer?

Mr. RAMM. Then it would flow to the marketer, then in turn would flow to the end-user.

The CHAIRMAN. But if I as the major oil company do the blending, I do not pass that on to you?

Mr. RAMM. It is not being passed on.

The CHAIRMAN. But they could?

Mr. RAMM. They could.

The CHAIRMAN. But they are not?

Mr. RAMM. They are not. Some are, but not all. I wouldn't know exactly which terminals and which companies are. I do know that there are some companies that have stated that they are not.

The CHAIRMAN. Okay. Thank you, sir. I will stop at this point and yield to Mr. Moran. I may have a follow-up question later. I yield.

Mr. MORAN. Mr. Chairman, thank you very much. Mr. Duffy and others, apparently the Senate has now passed the so-called farm bill by a vote of 81–15, which means we may have less reason. This includes the reauthorization of the Commodity Futures Trading Commission which means we may see less of you, unless we have more hearings on the price of commodities and the fluctuations of the market. So, maybe we will find another reason to have you and other participants back to talk about this topic. But, Mr. Etheridge, the farm bill is now on its way to the President. Let me see, what caught my attention in the testimony of this panel is Mr. Stallman's topic of convergence. Maybe this is a question Mr. Duffy or Dr. Newsome can answer. Is convergence based upon an economic theory? Is that what is supposed to happen despite some fluctuations? It is not perfect, but convergence should occur, and, if so, is Mr. Stallman, President Stallman, correct in his concern that it is not happening in today's market? What is the significance of that being the case? Is this a legitimate concern?

Mr. STALLMAN. Theoretically, law of one price says that at a given point in time, at a given location, assuming costless delivery, which is not the real world, the price, cash price, and the futures price contract should be equivalent. Now in the real world there are variations. There are differentials, but what has occurred, and we go back to look at what Dr. Kunda from the University of Illinois actually presented to the CFTC forum here, if you do the analysis, it looks like for some contracts that to hedge effectively, you

need to be able to depend on that convergence occurring at the end of the contract basically.

Mr. MORAN. So farmers in making their decision about hedging are relying upon a theory that says these prices will converge?

Mr. STALLMAN. Yes.

Mr. MORAN. And then is that, Mr. Duffy or Dr. Newsome, is that based in economic theory that is the reality of the way the market should work?

Dr. NEWSOME. Yes, sir, that is the way that the market should work. If the market is operating efficiently, the two prices should converge, and then you would therefore have very few actual deliveries of the underlying commodity. If the market is not operating efficiently and you don't have convergence, then you enter a different form of risk into the hedger's equation which is the basis risk. So you end up, again, having more risk to deal with than just the risk that you are trying to hedge to begin with.

Mr. MORAN. And when you were at the CFTC, Dr. Newsome, this would be something that the CFTC would be monitoring is whether convergence occurs?

Dr. NEWSOME. Absolutely they would monitor that.

Mr. MORAN. And is the trend, as Mr. Stallman outlines, that there is something different about todays market when it comes to convergence than we have seen historically?

Dr. NEWSOME. I don't spend time looking at the agriculture markets that he was discussing, so I don't have any specifics on that.

Mr. MORAN. What is true in the petroleum, the oil market?

Dr. NEWSOME. The crude oil market is operating very efficiently. We are having price convergence. We have had fewer than 1,300 contracts over the last year and a half go to delivery which is the prime example that the market is operating very efficiently.

Mr. MORAN. Mr. Duffy.

Mr. DUFFY. Congressman Moran, we have studied the convergence issue quite a bit, especially recently with the increase in the prices of agricultural products. We work closely with the commodity markets and bring in all different groups into the exchange to work with them. There are a number of factors that go into the convergence issues. We are actually asking some of the same questions of why the non-commercials are not arbitrating the price between the cash and the futures so we can have convergence. There are also factors of freight cost and storage cost that are variances and that convergence equation, and we also as you know, we have just applied with the CFTC for a swaps contract on convergence between cash and futures, which we think will help mitigate this problem. But, the convergence issue has actually taken care of itself. The market has worked quite effectively over the last several expirations, and we have had convergence in our agricultural products.

Mr. MORAN. But, Mr. Stallman, you are saying something is different today than it has been historically?

Mr. STALLMAN. Well, the numbers we were looking at were comparing the 2001 to 2005 period with 2006 to 2008 period. So, it was a historical comparison. I think recent activity has indicated that the convergence is better than what it was.

Mr. MORAN. I am about to lose my time, but in fact maybe it is gone. Anybody have anything they want to tell me about this topic that I haven't asked? Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you. The gentleman from Georgia, Mr. Marshall, for 5 minutes.

Mr. MARSHALL. Thank you, Mr. Chairman. I got my rant off my chest with Mr. Harris and Mr. Fenton, and at this point would like to hear, Dr. Newsome, your comments about Mr. Ramm's testimony. In fact, it turned out that your opening statement written, I assume, without having looked at Mr. Ramm's opening statement or heard it, kind of addressed what he was asserting. But, it would be helpful for us to hear specifically what you thought was off the mark in his assertions. And then, Mr. Ramm, if you are in a position to do so, if you could respond, that would be pretty good.

Dr. NEWSOME. Well, we certainly didn't have access to Mr. Ramm——

Mr. MARSHALL. I understand.

Dr. NEWSOME. And the first we heard it was when he gave it sitting next to me. I guess a couple of comments, Mr. Marshall. One, the margin issue in my opinion is only an issue if you believe that speculators are in fact artificially moving prices. We do not believe that is the case, and we think we have the data to show that is the case. So given that fact, the margin issue becomes a moot issue as far as we are concerned.

Mr. MARSHALL. That is number one. I think from the speculative standpoint, and we show the actual numbers in the chart, I would go beyond that to say even if you bought into the theory that speculative long positions were driving the market higher, I think you have to look at the flip side of that. Because they are speculators, they do not have the ability to make or take delivery so they have to trade out of that contract prior to expiration. So then where is the down side that should also be put on the marketplace when the speculators are trading out of their positions? It doesn't occur. It doesn't exist. And, therefore, that is part of our philosophy as to why speculators are not driving these higher prices.

And just one too, that is it, Mr. Ramm. Do you——

Mr. RAMM. I guess we get our position from a couple of things. One is that in looking at the testimony that Stephen Simon from ExxonMobil gave who is Vice President of the largest oil company in the United States that their fundamentals say that oil is at $50 to $55 and then $127 means that it still looks like there is something other than maybe the weak dollar that might be involved in this. The other thing is that in the NYMEX and also in CME those are regulated markets, and there is full transparency there. I think that all of the data that we see is showing that there is not excessive speculation on those trading platforms.

What we would say is that there is activity outside of those and I think was referred to as a dark market or an opaque market, that those types of trades are not being seen, and it is increasing.

Mr. MARSHALL. Something like the tulip craze is going on here, and prices are being bid unrealistically high by investors that are not very sophisticated and don't understand fundamentals. Is that why they are way up over twice what the barrel of oil should actually bring?

Mr. RAMM. Well, I think that what we have seen is also some correlation to just the amount of cash that has moved into those markets from other areas. Like when the subprime hit there was a lot of cash that moved into commodity market trading, and then in turn there was quite a bit of increase in price.

Mr. MARSHALL. Dr. Newsome, your response on $50, $55 fundamentals?

Dr. NEWSOME. Well, I think it is interesting to step back and look at the amount of information that is available, and there are basically two entities that have the information about speculative positions, the CFTC and NYMEX. Both have taken the position that given the data, given the numbers, speculators are not responsible for the upturn. People have talked about it so much, I think a lot of people have just come to believe that it is a fact.

Mr. MARSHALL. You are basically saying this guy is wrong when he thinks the fundamentals are at $50 to $55?

Dr. NEWSOME. I absolutely think that he is wrong.

Mr. MARSHALL. And what about the assertion that this dark pool of money that is out there that we can't see as Mr. Duffy pretty aptly described it, that all kinds of money has flowed there. You have said that the commercial side is dominating right now, trading where oil is concerned at least on-exchange. And could it be that off-exchange there is something going on that we just don't understand and don't know about that is causing this?

Dr. NEWSOME. Well, two things. One, about the $50–$55. If oil companies really believe that was the case, they would be selling everything that they could currently get their hands on in today's market. That is not the case, so what they are saying and what they are doing are two very different things. All I can do is present the information that we have in NYMEX, and that is what I have done today. There is no doubt that in the less transparent markets things can go on. We don't have access to that. CFTC doesn't have access to that. I do know at the end of the day transparency is a key component for a competitive marketplace, and the more we can make these markets transparent the better.

Mr. MARSHALL. May I just ask one more? How do you compare the size of the market, those two markets, your market? Don't you have the lion's share of the trading activity that goes on? Isn't the OTC market fairly small or can you not even tell?

Dr. NEWSOME. No, the OTC market in crude oil is huge, and we would estimate that exchange traded market with regard to crude is 20 to 30 percent of the overall OTC market.

Mr. MARSHALL. And do you understand the OTC market to be paying attention to the values that are set on your exchange and doing their deals?

Dr. NEWSOME. Typically the settlement price that is determined at NYMEX is at least a component of the pricing mechanism of the OTC.

Mr. MARSHALL. Thank you for your indulgence, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. Since there are only three of us with your indulgence, you have been kind enough to come and wait, we are going to do a second round very quickly, and then move to our next group. Mr. Duffy, the National Corn Growers Association in their testimony state they have forwarded to the

Chicago Board of Trade several recommendations, including investigating methods to allow farmers that have taken short positions to actually deliver against future contracts. Second, implement a forced loan out plan whereby some set percentage of contracts have to go to delivery, third, increase storage rates. And, finally, investigate the establishment of base contracts. What are your thoughts on this proposal if you had time to study it?

Mr. DUFFY. Mr. Chairman, I apologize. I do not have a copy of that economic study from the Corn Growers Association on what they are proposing, and I think I will go one at a time, you said on the first one that limit the ability or increase the ability of having the participation of making delivery but a small——

The CHAIRMAN. Small.

Mr. DUFFY. They have that ability today to make delivery on the contract. The contract does not discriminate from making or taking delivery.

The CHAIRMAN. Okay. I am sorry. I thought maybe you had this. It was something that was submitted in testimony. I will share it with you, and if you could just sort of share it back with us to the Committee, it would be fine. Ms. Campbell, you have been named as a member of the CFTC's new energy market advisory committee. Congratulations. I guess my question is what are your expectations for this committee, and what will you be pushing for the CFTC to accomplish when you meet with them in your first meeting next month?

Ms. CAMPBELL. Well, the very first thing is that we are really hopeful that the Title XIII of the 2008 Farm Bill is going to go a long way to address the transparency issues that the other folks on the panel have raised. So, the very first thing will be to start to look at the materials that are coming back, the information that is coming back and assess whether we have further action that needs to be taken by the committee.

The CHAIRMAN. Thank you very much, and I would yield to the gentleman from Kansas for 5 minutes.

Mr. MORAN. I would yield to Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Moran. Mr. Duffy, I would like to follow along the same line of questioning that I was addressing to Dr. Newsome. The public counter market, and this isn't necessarily limited to oil, but to all of these commodities that seem to be rising very rapidly in price, can you think of ways in which the over-the-counter market—well, first, if you would, describe the size of the over-the-counter market compared to the——

Mr. DUFFY. Regulated exchange derivatives are listed products on exchanges today has a notional value of $77 trillion. Over the counter look alike derivatives have an estimated notional value of $415 trillion, so roughly six times larger than that of a regulated platform. An agricultural commodity at the CBOT, the grain products have roughly a notional value of $80 billion. On an over-the-counter grains look alike contracts the notional value is about $270 billion.

Mr. MARSHALL. Though you are with the exchange, you are in the business, you generally know how the over-the-counter market works, the different kinds of instruments that are out there, transactions that occur, can you go ahead and share with us ways in

which the over-the-counter market could be causing artificially high prices where commodities are concerned?

Mr. DUFFY. Mr. Marshall, in my testimony we are not accusing the over-the-counter markets of manipulating price at all. All we are saying is these exempt commercial markets, no one knows the activity of their participation or the level of their participation. I congratulate the Congress on passing the farm bill, and in that farm bill, Congressman Moran mentioned that the reauthorization was done in that there was some provisions as it relates to energy.

Mr. MARSHALL. Yes, just energy though.

Mr. DUFFY. There were some provisions but there was one lacking and that is position limits. It was not required. And that is probably the most important component that you could have in the transparency of the market to have position limits accountability.

Mr. MARSHALL. Well, and position limit is intended to do what? To limit the risks associated with failure to sort of protect? So when you mention position limits as a problem in the OTC market, it is principally one that could cause a systemic failure if we don't know——

Mr. DUFFY. Again, sir, we are not accusing or——

Mr. MARSHALL. Well, I understand you are not accusing. I am just asking for speculation.

Mr. DUFFY. One of the things I learned a long time ago when I became the Chairman is not to speculate. I speculated for 23 years as a trader so I decided speculation should be out of the equation. And again we can only go by the facts. We are just saying that these exempt commercial markets should look the same since they are look alike products as a regulated exchange and——

Mr. MARSHALL. You are making that suggestion because you are at a competitive disadvantage. There are lots of folks out there——

Mr. DUFFY. No, sir. No, sir. I think that the CME Group has expanded its business dramatically, and we have made the notions that we are going to enter into the over-the-counter markets. We have the capabilities and facilities to do so except the products that we are listing for trade that we are going to do over-the-counter. We are also going to go by the same requirements that we have in our regulated products.

Mr. MARSHALL. Can any of the witnesses offer just some thoughts about how if it is possible the over-the-counter market could be causing prices to surge inappropriately? I take it from your silence that none of you despite your——

Mr. RAMM. I think I would just make one comment that the fact is they don't know because those numbers aren't being seen. No one sees that today, so I think that if the numbers were seen then they could see if there was, but I am sure there are ways of doing it. Whether it is happening or not, nobody knows.

Mr. MARSHALL. Dr. Newsome, from your response to the suggestion that market fundamentals have price per barrel at $50 to $55, if that is the case people would be selling like crazy—let us capture the profit now. Don't you think the over-the-counter market works the same way? I mean different types of instruments, transactions, *et cetera*, but are parties also rational?

Dr. NEWSOME. Well, I think because of the very nature of that market is two sophisticated participants striking a deal with each

other so that level of sophistication I think probably keeps the contract relatively fair. I think the point of concern is the financial integrity of the overall marketplace and the fact that you could have an Amaranth type scenario that creates damage for legitimate market participants.

The CHAIRMAN. I think we all agree.

Dr. NEWSOME. But I think since I was the Chair of the CFTC back when the CFMA was passed obviously we had no crystal ball at that time, and markets have changed dramatically over the last 7 or 8 year period. What we have seen in the OTC markets is really a move away from the very individually negotiated contracts to trading more of exchange look alike contracts that serve the exact same function as an exchange contract. At the end of the day if it looks like a duck, acts like a duck, walks like a duck, it probably is a duck.

The CHAIRMAN. I thank the gentleman. Thank you. The gentleman from Kansas, 5 minutes.

Mr. MORAN. Thank you, Mr. Chairman. Mr. Ramm, one of the things that is pleasing to me about your testimony is that it provides some relatively specific recommendations, and I don't—I am happy to have you explain any of those things. I was particularly looking at what you suggest the Congress and the Administration might consider. I am happy to have you expand upon what you have in your testimony, but I would be interested in also hearing what other participants on the panel have to say about the consequences of those recommendations. Mr. Ramm, do you have anything to add to your recommendations to your testimony?

Mr. RAMM. Well, as we made those recommendations, we are cognizant of liquidity and making sure that there is liquidity. We agree that the regulated markets are working well. Again, it comes to this opaque market, and no one knows what is going on. So when we looked at raising margins—this is a crisis that we are under. Petroleum marketers throughout the nation are going to be out of business because they can't afford to carry the farmer anymore because their credit lines are getting too high. The banks have quit lending us money. The risk is too high. Our margins are low. The risk reward for a tanker load of diesel today at $40,000, we net maybe less than $100. Our gross is about $600, but that is before freight.

And our farmers can't even establish a credit line with us anymore for the fuel that they need to be able to go out to the farms with, so this is a crisis. We are looking at some type of solution to try to get some control over this what we feel is an out of control market. It seems to be dysfunctional.

Mr. MORAN. Thank you, Mr. Ramm. Dr. Newsome, do you have any responses to the seven items? You have seen Mr. Ramm's testimony or heard his testimony.

Dr. NEWSOME. Well, just from what I heard, Mr. Moran, what I would prefer to do is really to look at them and respond back to the Committee with more thoughtful comments.

Mr. MORAN. That would be fine, Dr. Newsome. Raising margin requirements, just a general reaction, whether that is a good idea or bad idea?

Dr. NEWSOME. I think that is a bad idea for a couple of reasons. One, because you would only address that if you believed that it was speculative money that you are trying to control. We don't believe that is the case.

Mr. MORAN. So if you start with the premise that it is not speculation that is causing the problems then the solutions suggested by Mr. Ramm would not be appropriate?

Dr. NEWSOME. Absolutely.

Mr. MORAN. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Let me ask this question, going back to the institutional investors. Would you interpret the fact that because they are bringing needed liquidity into the market that the investors could very well be bringing some needed stability to the markets?

Mr. DUFFY. I will be happy to respond to you, Congressman, and if the Committee will allow me, I will tell you a quick story about how investors can help the producer on markets that go down as much as what happens when they go up. In 1998, we had post-World War II lows in the price of the hogs in the United States here, and the nearby contracts were severely depressed in pricing. But the back end of the market, the futures market, was at a premium because the speculator or the investor felt that the market was entirely too low, and it kept the market higher. It kept buying the market which in turn gave the producer hedger an opportunity to sell into that in order to protect their crops or their hog production, which they did, and a lot of them survived in business.

When the markets go up or the markets go down investors, their appetite for risk is great, and it is a good thing they are there on both sides of the market. I think they are essential to the efficiency of any marketplace, whether it is going up or whether it is going down. And the fundamental factors, and that is what this hearing seems to be more about whether the pricing is obvious that it is fundamentally driven.

Mr. SCOTT. Do you all believe that in the new farm bill there was some new substantial powers were given to the CFTC. Dr. Newsome, do you believe those are adequate, and what are your thoughts on the new powers that were contained in the new farm bill for the CFTC?

Dr. NEWSOME. Congressman Scott, I think the powers given to the CFTC were adequate as it relates to natural gas markets, but it only addresses natural gas at this point. I think that same kind of authority can be very useful in some of these other larger OTC markets, and I think that is what some of the colleagues at the table are expressing this morning.

Mr. SCOTT. Okay. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. Let me thank each of you, each one of our panelists, for your patience this morning for staying through the hearing with the votes we had. Each Member may have an opportunity to submit to you written questions. We would encourage you to get it back to the Committee within 10 days should they do so. Thank you very much. We will now move to our third panel. Mr. Gary Niemeyer, who is a corn and soybean producer, on behalf of National Corn Growers Association; Mr.

Layne Carlson, Corporate Secretary and Treasurer, Minneapolis Grain Exchange; Mr. Rodney Clark, Vice President, CGB/Diversified Services, on behalf of National Grain and Feed Association; Mr. Thomas Farley, President and Chief Operating Officer of ICE Futures U.S., New York; Mr. Andy Weil III, President, American Cotton Shippers Association, Montgomery, Alabama. Mr. Niemeyer, please begin when you are ready, 5 minutes. And I would only just remind all of you that your total statements have been entered into the record, and if you will try to summarize it in about 5 minutes. Thank you.

STATEMENT OF GARRY NIEMEYER, CORN AND SOYBEAN PRODUCER, AUBURN, IL; ON BEHALF OF NATIONAL CORN GROWERS ASSOCIATION

Mr. NIEMEYER. Good morning. I am Garry Niemeyer, and I am a corn and soybean farmer in central Illinois. I am here today representing the National Corn Growers Association. NCGA represents the interests of over 32,000 corn farmers throughout the United States. For over 100 years, commodity exchanges have played two valuable roles critically important to farmers, price discovery and risk management. Over the last several months, though, we have witnessed a lack of convergence between cash and futures markets as the futures contract expires. Without market convergence the futures markets are not fulfilling the role of price discovery, leading us to question whether market fundamentals still underpin current grain prices.

Corn growers are not upset about higher corn prices. Our concern is that the current prices may not be fundamentally supported. This is leading people to speculate that we may be witnessing the development of a commodity bubble. As this bubble inflates, it has harmed the elevator industry and has been devastating to our livestock customers. I should point out the corn that I grow, I produce, is railed to the Texas Panhandle to feed cattle, so I am very sensitive to the price impact to livestock feeders. In early March we saw the bubble's first impact when the grain elevators were hit with tremendous margin calls. In response, many elevators suspended or severely restricted forward contracting. One of my local elevators will not even contract for grain this fall.

As a farmer, how am I supposed to manage my price risk if my elevator will not contract grain? Farmers have always had the ability to do their own risk management on exchanges, but it is estimated that less than 10 percent of the farmers use this tool themselves. Lacking other hedging opportunities, growers will have to absorb the cost and risk of the futures market. In today's market conditions, these costs and risks are not insignificant. In the end, the unwillingness of commercial players in the market to offer forward cash prices has effectively transferred the market risk onto producers and producers still do not have a means to offset this basis risk.

NCGA is not blaming the elevator industry for their recent phenomenon. The elevators are businesses that must be able to recoup losses and manage price risk. During the last several years, we have witnessed a tremendous increase in input cost, especially fertilizer and diesel fuel. In March, my fertilizer dealer asked me to

lock in my fertilizer for the crop that I will plant next spring. The prices for anhydrous, DAP, and potash have risen 52, 100, and 118 percent, respectively, since last fall, and the trend is pointing to even higher prices by this fall. Since no elevators are offering this on the 2009 production, my options are simple and unpleasant. I can borrow more money to buy the fertilizer and borrow more money to finance risk management on the exchange or I can stay completely exposed.

As I had mentioned, NCGA's concern is the development of a commodity bubble and now the hope is that the bubble doesn't burst. This bubble was not caused by ethanol. Instead, it has been caused by dramatic increase in non-traditional investors in all commodities. It is the general investment pattern of the index funds that has inflated this bubble. These funds take huge net long positions—buy futures—which given the volume of purchases naturally drives prices higher. Our challenge is to restore the efficiency in price discovery and risk management without jeopardizing the market openness and liquidity. In light of that goal, NCGA would like to submit the following possible solutions for the consideration.

First, to address the lack of convergence in between cash and futures markets, we must simply fix the delivery system. Second, and more importantly, we must find a way to head off the development of the commodity bubble or if it has already occurred stop it from bursting. Several possible solutions include: since large funds are having a disproportionate influence and are non-commercial traders, they should be treated as speculators counter to several CFTC decisions, we believe, to truly be classified as a hedger an entity must have a cash commodity position. This would still allow the large funds to take their net long positions, but they will have higher margin requirements just the same as any other speculator.

Number two, short of redefining all players without cash positions as speculators, the CFTC and exchanges should implement a moratorium on providing a hedger status to any of the non-cash traders. I have several other positions that I would like to talk about, but I will answer the questions when asked.

[The prepared statement of Mr. Niemeyer follows:]

Testimony

of

Gary Niemeyer
National Corn Growers Association

Before the
U.S. House Agriculture Subcommittee
on
General Farm Commodities and Risk Management

Longworth House Office Building
Room 1300
Washington, DC

May 15, 2008

Good morning, I am Garry Niemeyer and I am a corn and soybean farmer in central Illinois. I am here today representing the National Corn Growers Association (NCGA). NCGA represents the interests of over 32,000 corn farmers throughout the U.S.

For over 100 years, the commodity exchanges have played the two valuable roles critically important to farmers; price discovery and risk management. Over the last several months, though, we have witnessed a lack of convergence between cash and futures markets as the futures contract expires. While the corn market has experienced significant lack of convergence, it is nothing compared to what has occurred in the wheat pits.

Without market convergence the futures markets are not fulfilling the role of price discovery. It leads many to question whether market fundamentals still underpin current grain prices. Economic theory suggests convergence is not really a point at zero, but a band of plus or minus a few cents either side of zero, varying based on current supply and demand factors. Further, it is natural to assume that the increased risk inherit in the grain markets would cause the "band of convergence" to expand from historical norms, but is 35 to 50 cents a real true measure of this risk? If the constant media barrage about scarcity is to be believed, you would certainly think the cash grain markets would converge closer to zero rather than spreading dramatically.

Moreover, a weakening of price discovery is rippling into the farm credit system, resulting in banks having difficulty in collateralizing loans to elevators and farmers, alike.

It is this tightening in the agriculture credit markets that is setting the stage for a more serious problem.

It is our position that the lack of convergence is a symptom, not the disease. For a number of reasons, some of which I will detail later, grain markets are not performing with the efficiency in past years and this places farmers directly in the path of an economic storm.

Please do not misconstrue this point. Corn Growers are not upset about higher corn and grain prices. Our concern is that the current prices quoted may not be fundamentally supported. This is leading people to speculate that we may be witnessing the development of a "commodity bubble." As this bubble has inflated, it has resulted in hardships for the elevator industry and has been devastating to our livestock customers. The sharp rise in prices has also impaired many growers' ability to do price risk management.

To those who want to blame biofuels for today's grain prices, I will simply state a close examination of the facts and market trends would indicate that such claims are difficult to substantiate. In the 2005-06 marketing year when the first Renewable Fuels Standard was approved by Congress, average farm-gate price for corn was $2.00 per bushel On May 9, 2008, USDA released its revised estimate for this marketing year's corn price at $4.10 - $4.40. So what has changed? The simple sound bite is to point to ethanol and say "we've increased the demand for corn driving up the price". During the last 3 years, corn for ethanol has increased from 1.6 billion bushels to a projected 3 billion, a 1.4 billion bushel increase in demand. What frequently gets overlooked is that over this same time period production has risen from 11.1 billion to 13.1 billion bushels over this time. This raises the question how a 2 billion increase in usage offset by a 2 billion bushel increase in production provides the necessary fundamental underpinning for a more than doubling of the corn price. Now contrast this estimated $4.25 corn price received to the May 12, 2008 closing price on the Chicago Board of Trade (CBOT) for July futures, $6.14 ¾. Although an imperfect comparison, it illustrates there is a significant difference between the prices farmers are receiving and the futures market.

The real damage to the elevator industry hit home in early March when many elevators took major hits on margin calls. Several leading grain companies' initial response was to suspend forward contracting. While the suspension was short lived, severe restrictions were placed on new contracts once forward contracting was re-established. These restrictions on new grain contracts are the most troubling. Each of the large grain companies have instituted limits on writing new grain contracts. One company will not forward contract grain more than 60 days out. Two others will not contract grain more than 12 months in the future. Naturally, this has permeated down to the country elevator level. One of my local elevators will not contract for grain this fall and I assure you this is not a central Illinois phenomenon, but it is occurring across the country. As a farmer, how am I supposed to manage price risk, if my elevator will not contract grain? I am not talking about locking in prices 2 and 3 years into the future. But, how do I manage risks for the corn crop I would be planting today if it had not rained Tuesday?

Over the last several years, farmers have grown accustomed to the elevator industry's willingness to carry the futures market risk for us. It has been quite common for us to do Hedge to Arrive contracts with the local elevator. The elevator would take the offsetting positions on the CBOT and absorb any margin risks. Of course, some of this risk would eventually be bid into the basis. During periods of little volatility, though, this risk premium was not that great. In return for carrying that risk, elevators were also able to lock in volume. Elevators make their profits in handling bushels. But, it is the more recent wild volatility and subsequent margin calls that have led to the restrictions on contracts. For example, one of the larger grain companies that re-established contracting for 12 months forward has implemented a 15¢ per bushel fee to write a HTA. It is worth noting that new fee is 15¢ in addition to what ever the basis might be when I am ready to deliver the grain.

Although farmers have always had the ability to do their own risk management on the exchanges, it is estimated that less than 10 percent of farmers actually do this themselves. Perhaps we have been spoiled because the elevators were willing to provide this service. Now, we will have to absorb the cost and risks of the futures market. In today's market conditions, these costs and risks are not insignificant. Let me give you a very simplistic example of how this might impact a grower. Last year, I produced about 360,000 bushels of corn. If I did a simple short hedge on this grain (sell futures contracts to protect against falling prices), I would need to sell 72 contracts (5,000 bushels per contract). Let's assume I did all of that on September 4, 2007 (when the grain was harvested) for delivery in May. On that day, May corn futures closed at $3.79/bushel. The typical margin, maintenance margin, and commission would have cost me between $110,000 and $150,000, which is money up front I send to Chicago. On May 1, 2008, May corn closed at $6.05 a bushel, an increase of $2.26/bushel. Since I had a short position (lose money if the price goes up), I would have lost $2.26 per contract. To maintain my maintenance margin, I would have been required to lay out an additional $750,000. Technically, I would have made this money back on the increased cash price of my physical corn, assuming the cash and futures prices tracked perfectly and did not diverge. Still, I would have had to finance and pay interest on this $813,000 until I could sell the cash corn. In the end, I would have stayed even at around the cash price on September 4th. Keep in mind this does nothing to protect me against basis risk.

Given the higher current prices on the exchanges, margin requirements have more than doubled since the end of 2007. In December 2007, for example, the margin on a corn contract was $1,080 and the maintenance margin was $800 (covers a 16¢ move against my position). Today, that same contract has a margin of $2,050 and the maintenance margin is $1,500. Once again, that is money I have to spend up front on each contract.

Another alternative is to use the options market and buy a put. While the options market does not carry margin risks, the premium associated with that put is cash paid up front regardless of whether or not I exercise the option. Last September when the futures price for May was $3.79, there were no strike prices comparable to today's prices. The increased market volatility has dramatically increased premiums, especially for crops

well into the future. For another example, let us assume I wanted to buy a put today for May 2009 contracts. These 72 puts would cost approximately 237,600 in premium and commissions. As I mentioned, this is money that is gone regardless of whether or not I exercise the puts. The question is what corn prices have I guaranteed for $237,000? $5.07/bushel. (May 2009 Corn Futures $6.58, Option with $6.10 strike price has a 65¢ premium reducing the Option price to $5.45. The one elevator offering a bid for May 2009 has a 38¢ basis which equal $5.07/bushel, assuming that basis does not erode).

The unwillingness of commercial players in the market to offer forward cash prices has effectively transferred the market risk onto producers and producers still do not have a means to offset the basis risk. A very real danger is a significant number of growers will forgo price risk management out of hope that prices will continue to rise. However, such a strategy will prove devastating if a significant downturn in corn prices occurs.

NCGA is not blaming the elevator industry for this recent phenomenon. The elevators are businesses that must be able to recoup losses and manage price risk. So, they spread basis to cover losses and build in additional risk principles; initiate fees on Hedge to Arrive contracts (HTA) or book the basis contracts; or they just forego future risk by not offering forward contracts. In the end, these actions transfer the risk back onto growers. The main risk elevators retain is the inability to lock in bushels.

What could happen if the "commodity bubble" pops? I can best illustrate this with an example. During the last several years, we have seen a tremendous increase in input costs. Fertilizer prices have more than doubled in the last two years. Likewise, diesel prices are skyrocketing. I like to consider myself a good manager, so, I try to forward price half of my expected grain production to at least cover my input costs. Last fall, I purchased my fertilizer for this year's crop. Anhydrous Ammonia was $512/ton, Diammonium Phosphate (DAP) was $476/ton and Potash was $287/ton. Since then, we have seen an explosion in prices and concerns about availability next year. In March, my fertilizer dealer asked me to lock in my fertilizer for the crop I will plant in 2009. The prices for Anhydrous, DAP, and Potash were then $780, $950, and $625/ton, respectively. Coincidentally, between March and May, those prices have continued to increase to $830, $1,150 and $725. The trend is clearly pointing to even higher prices by this fall. Once again, I typically manage the risk of fertilizer prices by forward contracting a portion of my grain. However, no elevators are offering bids for new crop 2009 corn. My options are simple and unpleasant. I can borrow money to buy the fertilizer now, and remain completely exposed to a down turn in corn prices, or wait and remain completely exposed to the price of fertilizer continuing to rise. I am left to hope that should a downturn in grain prices occur, fertilizer prices would drop proportionally with grain prices, a very unlikely outcome.

As I have mentioned several times, NCGA's concern is the development of a commodity bubble and now hoping that the bubble doesn't burst. This bubble was not caused by ethanol. Instead, it has been caused by a dramatic increase in non-traditional investors in all commodities, not just corn, specifically, index and hedge funds and swap dealers. Commodities have traditionally been a prudent investment during periods of economic

uncertainty. With huge influxes of outside money indicating these investors are returning it is no coincidence the recent run up in commodity prices coincides with the downturn in the stock market.

More importantly, we are concerned with the general investment pattern of the Index Funds that have inflated the bubble. These funds take huge net long positions (buy futures) which given the volume of purchases naturally drives prices higher. Their claim of being "Passive Longs" is partially true. They are not playing both sides of the market, only betting that the price will go up. The funds claim they are not responsible for the divergence between cash and futures because of the roll out of their long positions approximately a month before contract expirations. The latter part of this statement is true. However, one theory about the lack of convergence is the funds have driven a large enough wedge between the two markets when they complete their rolls and that it would take a significant fundamental signal to drive cash and futures together. The likelihood of this happening in a month's time, particularly when the crop is not exposed to a production event, is slight.

The commodity exchanges' strength has always been liquidity, openness, and fair and transparent rules. Unfortunately, we have seen erosion in market efficiency. The challenge is to restore efficiency in price discovery and risk management without jeopardizing market openness and liquidity. In light of that goal, NCGA would like to submit the following possible solutions for consideration:

First, to address the current lack of convergence in between Cash and Futures markets: Simply to fix convergence in the market, we must fix delivery. The problem, there are no easy solutions to this task. Here are a few recommendations; we put forward to the CME Group.

1) Investigate the development of a method to allow farmers or small elevators that have taken a short position to actually deliver against that futures contract. Currently farmers cannot make delivery against these positions. Farmers can only sell futures and deliver against shipping certificates, provided the owner of that certificate plans to make delivery and go to load out. If the delivery stations realized that a farmer or an elevator could call a clearinghouse and set up delivery, it would cause the commercials to drive the futures down at contract expiration to the cash price. A possible hybrid would be to restrict farmer delivery to only a few points with a 1 or 2 day delivery option.

2) Investigate implementing a forced Load Out plan whereby some set percentage of contracts has to go to delivery. During the investigation, consideration must be given to how these Load Outs would be distributed, and what impact this may have on liquidity if the non-commercials are prematurely driven out of the market prior to contract expiration.

3) Investigate increasing the number of shipping stations. By our count, there are currently 28 shipping stations approved as "regular" for corn delivery through June 30, 2008. These stations are limited to 9 firms. Of these 9 firms, only 2 are truly sellers. In

other words, they can write a shipping certificate, but since they cannot use the grain internally (processing or through their own export facilities) they must sell the grain, and therefore, may be more inclined to make delivery against a diverged market. We believe balancing or at least increasing the number of sellers that can write shipping certificates may help to re-establish convergence. For example, there are a number of large ethanol plants operating or being built in proximity to the Illinois River. Some of these will have docks that can load out, if necessary. A similar approach would be to investigate adding shipping stations that are not located on the Illinois River, but are in the same homogenous market. Specifically, there are a number of unit train rail loaders which are all within 50 to 100 miles of the Illinois River which could deliver a train destined for New Orleans which is similar to a loaded barge on the river.

4) Consider lowering Regularity. If the Working Capital rate was lowered from $2 million to $500,000, and they reduce the volume down from 55,000 bushels, this might encourage some larger country elevators with existing agreements with docks or maybe railroads connections to able to be a write shipping certificates.

5) Consider increasing storage rates. NCGA is not opposed to periodic adjustments in CBOT's storage rates. These rates should more closely reflect actual storage costs. In addition, this may help build natural carry into the market.

6) Investigate the establishment of basis contracts. CBOT has proposed establishing a new basis contract to the CFTC. If the current situation in the grain markets continues, farmers will need a tool to manage basis risk just like they must now find tools to manage price risk. While this appears it could be beneficial in managing basis risk, it really has limited impact convergence

Second and more importantly, we must find a way to head off the development of a commodity bubble or if it has already occurred, stop it from bursting. Several possible solutions are:

1) Redefine hedgers vs. speculators. NCGA recognizes the valuable role all parties play in providing liquidity in a market. It is NCGA's view that the large Funds are having a disproportionate influence in the futures markets and are "non-commercial" traders. While we do not want to drive the index and hedge funds or swap traders from the market, they should be treated as "speculators". Counter to several CFTC decisions, we believe to truly be classified as a "hedger"; an entity must have a cash commodity position.

We realize that the large index funds are selling a commodity index and then going long in each of their market basket commodities which could be construed as a hedge. But, they are selling a market basket of futures prices, not a market basket of physical commodities. Therefore, their actions provide no market incentive for convergence and as I pointed out above, without convergence there is no price discovery.

NCGA proposes that the index funds, hedge Funds, and swap dealers no longer be afforded the same margin requirements as traditional commercial hedgers. Specifically, to be classified as a hedger, the entity must have a cash position. We are not suggesting that they have an equal or proportional cash position, but somewhere within that company they must be buying or selling cash grain to retain the "hedger" classification.

We believe this will have a very limited impact on market liquidity. The large funds are still welcome to take there net long positions in each commodity market, but they will have higher margin requirements just the same as any other "speculators".

2) Moratorium on hedger determination. Short of redefining all players without cash positions as "speculators", the CFTC and the exchanges should not implement a moratorium of providing "hedger" status on any other non-traditional traders.

3) Speculative Limits. NCGA supports the CFTC's decision not to temporarily increase speculative limits. We believe the proposed increases were ill-advised and would only increase the disparity between cash and futures markets.

4) Daily Trading Limits. NCGA formal policy states "NCGA will oppose an increase in daily trade limits on all commodity exchanges" (Policy IV-C, 14). It is our position that the proposed increase in daily limits will not aid price discovery as proposed. Instead, this will only increase volatility. The CME Group should strongly reconsider returning to the trading limits that existed prior to their March 28, 2008 increase.

5) Renewable Fuels Standard. Congress must not repeal nor should the Environmental Protection Agency waive the current RFS. Numerous economic studies have indicated that the current ethanol demand has had a very limited role on the increase in corn prices. A repeal or waiver of the RFS would have a significant psychological impact on the commodity markets. In fact, this could drive investors from commodities causing the bubble to burst. Such a change in policy may have a short run impact on corn prices, but in the face of current high input prices, it would cause a significant shift of acreage away from corn and other feed grains in the near future, resulting in another dramatic rise in feed prices by 2009.

If in fact a "Commodity Bubble" is developing and that bubble was to pop, the entire grain sector would be devastated. Similar to the increase in grain prices, other input costs have risen dramatically, including for seed, fertilizer, fuel, or land rents. Farmers are now carrying significantly higher financial risk to plant their crops. A rapid deflation in grain prices would result in tremendous financial losses to farmers, especially in light of our recent inability for growers to contract grain at these current prices. If a disconnect between futures prices and cash (fundamentals) exists as alluded to earlier, the impact of the bubble bursting would be all the more dire. For this reason, it is imperative that the CFTC review recent decisions concerning the market power some of the major players wield and take into consideration the potential impact pending decisions have from the perspective of inflating a commodity bubble.

I would like to commend the CME Group, the Minneapolis Grain Exchange, Kansas City Board of Trade, and the Commodity Markets Council for hosting a two-day meeting on market convergence in early April. Also, I would like to thank the CFTC for holding their open forum last month.

On behalf of NCGA, I would like to thank the House Agriculture Subcommittee for conducting this hearing and helping American farmers and grain markets to restore market efficiency.

The CHAIRMAN. Thank you, sir. Mr. Carlson, 5 minutes.

STATEMENT OF LAYNE G. CARLSON, CORPORATE SECRETARY AND TREASURER, MINNEAPOLIS GRAIN EXCHANGE, MINNEAPOLIS, MN

Mr. CARLSON. Thank you. Good morning. My name is Layne Carlson, and I am an officer of the Minneapolis Grain Exchange. It is a great pleasure to be here before the Subcommittee on General Farm Commodities and Risk Management, and speak on matters important to us and participants on our market. The Minneapolis Grain Exchange is both a Designated Contract Market and a Derivatives Clearing Organization, which means we clear all our trades executed on our market and assume the counterparty risk. We are also subject to CFTC oversight.

The Grain Exchange was first established in 1881, and is the only futures and options market for hard red spring wheat. Additionally, we have five financially settled index contracts based on interior cash prices of corn, wheat and soybeans. What happens to the price of those cash commodities is of significant importance to us. Participants from around the world now trade our contracts and that trend is expected to continue to grow. Trade volume and open interest records are routine events at the Grain Exchange. What happens on our markets has regional, national and now global importance. Conversely, what happens regionally, nationally and globally can have material effect upon our markets. For example, a drought in Australia will affect our spring wheat futures prices.

The general objects and purposes of the Grain Exchange are spelled out in our Articles of Incorporation. To facilitate the buying and selling of all products, to inculcate principles of justice and equity and trade, to facilitate speedy adjustments of business disputes, to acquire and disseminate valuable commercial information, and so forth. These stated purposes indeed hold a lot of weight and responsibility which the Grain Exchange takes seriously. Our futures and options contracts are available to all who wish to trade, both speculators and hedgers. From a regulatory perspective, we monitor trade activity for evidence of fraud and manipulation. The MGEX believes our new contract, our market participants, including some funds, have greater liquidity and have added that to the marketplace. These are benefits to all market participants. While institutional investors do participate in very small amounts in our marketplace, it appears that many environmental factors have been building for some time in the wheat market, and culminated early this year with dramatic effect.

The result was a rise in prices, both in the cash market and on our futures market. Over the past several years, wheat plantings and production have continued a downward trend. Meanwhile, demand remains high. Additional factors have exacerbated the existing and shrinking supplies of spring wheat such as has been mentioned before in other panels, wheat failures in Australia, weather factors around the world. Wheat stocks hit 30 year lows while U.S. wheat stocks dropped to 60 year lows. Meanwhile, the value of the U.S. dollar continues to decline, enticing others to buy wheat on our markets. This past winter the cash price of wheat increased dramatically. As a result, there are many instances when the

spring wheat futures market locked the limit price up. This hindered the price discovery and risk mitigation purposes for our futures contract.

Additionally, energy costs, fuel and fertilizer prices have continued to increase, and wheat is having to compete with other commodities for space for acres. Despite the volatility of futures prices that has occurred on our market, there was almost perfect price convergence between the futures and cash price on the first notice day for delivery on our March futures contract, but there are still other factors that may interfere in the price convergence process. Therefore, the Grain Exchange has introduced financially settled index contracts that force convergence between the futures and cash price. These contracts can be used as a compliment to the current delivery contracts or provide an alternative to those who want the benefits of a financial settlement. These contracts could also offer relief to those expressing concerns about the influence of funds and other institutional investors.

All parties will be able to rely upon the fact that there will be price convergence. As the settlement day approaches, those holding positions in MGEX contracts need not be concerned with who the position holders are or what the open interest is. The Grain Exchange has been involved in the cash and futures business for over 126 years offering valuable services to a varied and growing group of market participants. We do not have any control over the fundamental factors affecting the wheat market. However, we do want to make our futures contracts available to all participants for the purpose of price discovery and risk mitigation. To do that effectively and efficiently, the MGEX believe it is necessary to allow the widest possible range of market users to participate.

After all these years, the Grain Exchange stands by its statements in its Articles to promote the furtherance of legitimate business pursuits and to advance the general prosperity and business interests of the region and the nation. The Grain Exchange expresses its appreciation to the Subcommittee for this opportunity to express our views.

[The prepared statement of Mr. Carlson follows:]

TESTIMONY OF LAYNE G. CARLSON
CORPORATE SECRETARY & TREASURER
MINNEAPOLIS GRAIN EXCHANGE

PUBLIC HEARING TO REVIEW THE SOURCE
OF DRAMATIC MOVEMENTS IN COMMODITY MARKETS

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON AGRICULTURE
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT

Good morning, my name is Layne G. Carlson and I am an officer of the Minneapolis Grain Exchange (MGEX). It is a great pleasure to be here before the Subcommittee on General Farm Commodities and Risk Management, and speak on matters important to us and participants who trade on our market.

The Minneapolis Grain Exchange is both a Designated Contract Market (DCM) for trading futures and a Derivatives Clearing Organization (DCO) which means we clear all trades executed on our market and assume the counterparty risk. As a DCM and DCO, the MGEX is subject to Commodity Futures Trading Commission (CFTC) oversight of our trading markets and clearing operations.

The Minneapolis Grain Exchange was first established in 1881, and is the only futures and options market for Hard Red Spring Wheat, and five financially settled Index contracts based on interior cash prices of wheat, corn and soybeans. Clearly, our focus is on agriculture based contracts. What happens to the price of those basic cash commodities and the price of futures contracts is of significant importance to us. Being located in the Midwest these past 126 years, we are part of the bread basket of America. However, participants from around the world now trade our contracts and that trend is expected to continue to grow. Trade volume and open interest records are routine events at the MGEX, particularly last year and early this year. What happens on our markets has regional, national and now global importance. Conversely, what happens regionally, nationally and globally can have material effect upon our markets. A drought in Australia, for example, will impact the price of our Spring Wheat futures contract.

The general objects and purposes of the MGEX are spelled out in our Articles of Incorporation: To facilitate the buying and selling of all products, to inculcate principles of justice and equity in trade, to facilitate speedy adjustments of business disputes, to acquire and disseminate valuable commercial information, and, generally, to secure the benefits of cooperation in the furtherance of legitimate business pursuits, and to advance the general prosperity and business interests of the region and the nation.

Those stated purposes indeed hold a lot of weight and responsibility which the MGEX takes seriously. The MGEX believes it has exercised those burdens exceedingly well over 126 years by providing a demonstrated and valuable service to the public for price discovery and risk mitigation that goes beyond just the agriculture, merchandising, and food product sectors.

The MGEX offers both open outcry (traditional pit trading) and electronic trading. We believe offering trading electronically has expanded the opportunity for more market participants, which has lead to greater transparency in the price discovery process so important to the industry and public. Along with additional trade volume, the rise in open interest (futures positions which have not been offset) has provided greater liquidity so that position holders can more easily move into and out of the market with less exposure to price volatility. Another main tenant of a futures market is risk mitigation or transfer. This means a market participant can enter into a futures or options trade to offset a price risk elsewhere. The benefit comes when the other price risk moves within a reasonable and measurable correlation to the futures market.

Our futures and options contracts are available to all who wish to trade, both speculators and hedgers, and include those parties known as mutual funds, commodity funds, hedge funds, index funds, etc. From a regulatory perspective, we monitor trade activity for evidence of fraud and manipulation. We also monitor the identity of position holders and inquire about their intentions when necessary. The MGEX believes that new market participants, including funds, have improved (or tightened) the spread between bidders and sellers, and provided greater liquidity to the market. These are benefits to all market participants.

While institutional investors do participate in our markets, it appears that many fundamental factors have been building for some time in the wheat market and culminated earlier this year with dramatic effect. The result was a rise in prices both in the cash market and in our main Hard Red Spring Wheat futures contract. Over the past several years, spring wheat plantings and production have continued to trend downward. When possible, farmers are turning from wheat to growing more profitable crops, such as corn, which are also more likely to produce a crop because of genetically enhanced traits. Greater likelihood of a profit is obviously a motivating factor. While less spring wheat has been grown, demand has remained high, meaning consumption is exceeding production and eating into remaining inventories.

Additional factors have exacerbated the shrinking supplies of spring wheat such as back to back wheat crop failures in Australia, and weather factors in Canada, the U.S., Europe and Asia resulting in lower wheat production. World wheat stocks hit 30 year lows while U.S. wheat stocks dropped to 60 year lows. The world turned to buy wheat where it could; some countries halted wheat sales. Meanwhile, the value of the U.S. dollar decreased making U.S. wheat an enticing commodity to foreign purchasers. This past winter, the cash price of spring wheat increased dramatically. As a result, there were many instances when the spring wheat futures contract on the MGEX was locked the price limit up. This hindered the price discovery and risk mitigation purposes for the futures contract. Market participants and traders looked to the options market to establish a synthetic futures position. Our March futures contract was particularly impacted and the MGEX (along with the CME Group and Kansas City Board of Trade) petitioned the CFTC to increase price limits to reestablish the price discovery function.

With the rise in energy costs, fuel and fertilizer prices have increased dramatically. China is buying much of the world's steel production, so farm equipment prices are rising. Transportation costs are going up. Farmland available for production is not materially increasing, so wheat has to compete with other agricultural commodities for acres. These are all significant factors affecting the MGEX spring wheat futures market. These are also very much traditional supply and demand fundamentals we are observing over which the MGEX has no control.

Despite the volatility in futures prices that occurred in the MGEX March Spring Wheat contract, during the month of February in particular, there was almost perfect price convergence between the futures and cash price on the first notice day for delivery. Hence, the MGEX spring wheat futures contract worked as expected. However, factors such as transportation costs, stocks of wheat at delivery locations, wheat quality at delivery locations, etc. have the potential to interfere in that price convergence.

Therefore, the MGEX has introduced and offers financially settled index contracts to the marketplace that force convergence between the futures and cash price. These contracts can be used as a complement to the current delivery contracts or provide an alternative for those who want the benefits of a financial settlement. Fundamental factors will still play their part and price volatility will still occur; however, the settlement process will be consistent and reliable. This is certainly something that would be attractive to those providing credit to the futures industry. These financially settled contracts could also offer relief to those expressing concerns about the influence of funds and other institutional investors as, once again, all parties will be able to rely upon the fact there will be price convergence. As the settlement day approaches, those holding positions in MGEX Index contracts need not be concerned with who the position holders are or what the open interest is.

The MGEX is smaller than some contract markets. What happens or doesn't happen in those larger markets is not always representative of what is happening in our market. As such, when laws and rules focus on addressing issues deemed important to larger contract markets or the futures industry, it can have a material and unintended spillover

effect to the MGEX. In other words, a one size fits all approach to regulatory laws and rules may be easier to draft and implement, but it often creates unnecessary costs for the MGEX which is forced to address compliance issues not present in our size market. This comment is intended only to advise caution in placing additional burdens on the marketplace because of recent price movements in commodity markets. The rule of unintended consequences may be the unfortunate result.

The MGEX has been involved in the cash and futures business for over 126 years, offering valuable services to a varied and growing group of market participants. We believe the MGEX is in the best position to know our markets and the commodities we offer for trade. If we notice a deficiency in a contract specification, for example, the MGEX will move to change the specification so that the marketplace will want to use and trade the contract. The MGEX does not have any control over fundamental factors affecting the wheat market. However, we do want to make our futures contracts available to all participants for the purpose of price discovery and risk mitigation. To do that effectively and efficiently, the MGEX believes it is necessary to allow the widest possible range of market users to participate. After all these years, the MGEX still stands by the statements in its Articles: promote the furtherance of legitimate business pursuits, and to advance the general prosperity and business interests of the region and the nation.

The MGEX again expresses its appreciation to the Subcommittee for this opportunity to express our views on this very important topic. That concludes my testimony.

The CHAIRMAN. Thank you. Mr. Clark, for 5 minutes.

STATEMENT OF RODNEY CLARK, VICE PRESIDENT, CGB/DIVERSIFIED SERVICES; CHAIRMAN, RISK MANAGEMENT COMMITTEE, NATIONAL GRAIN AND FEED ASSOCIATION, MT. VERNON, IN

Mr. CLARK. Thank you, Mr. Chairman and Mr. Moran, for calling today's hearing. My name is Rodney Clark. I am Vice President for CGB Enterprises, and I am Chairperson of the NGFA's Risk Management Committee. CGB/Diversified Services Division, which I am responsible for, provides risk management solutions to farmers and ranchers, including grain marketing strategies and crop insurance. We are one of the 16 companies that helped deliver and service the Federal Crop Insurance Program. I am here today representing the National Grain and Feed Association. NGFA members are intimately aware of the challenges currently inherent in the futures markets since we use them every day to hedge our risk. Without them, we cannot effectively run our businesses.

In my brief comments, I would like to share what we believe are the two most important issues involving the futures market today, and end my comments by suggesting two important solutions that we have already proposed to the CFTC. I will begin with the issue of convergence and basis, of which we have already heard a lot here today. NGFA member firms have relied on U.S. agricultural futures markets to hedge their price and inventory risk. In addition, part of our daily business is to advise and counsel producers and ranchers to do the same. We count on well-functioning futures markets for price discovery and risk management.

One of the bed rock fundamentals upon which hedging strategies are predicated is consistent and reliable convergence of cash in futures markets. Allow me to explain. Cash values are what the grain is really worth. It is what a buyer and a seller agree to in exchange for the actual commodity. It is what the commodity is really worth. The difference between this real cash price and the price which is reflected in the futures markets is called the basis. In properly functioning markets, the difference between the cash price and the futures price theoretically become the same as the futures contract enters its delivery period. Theoretically, the basis goes to zero. While there are many reasons why this seldom happens perfectly, the markets have historically functioned properly when the two markets converge in a predictable level.

Today, convergence is occurring less often and only for very short periods of time. There are many factors that have contributed to this, transportation costs, storage rates, higher prices in and of themselves have had an influence on the lack of convergence. Ultimately, given time the futures markets may adjust and rediscover balance on their own, but we do not want to run investment out of U.S. agriculture. However, in today's environment we believe agricultural futures markets need to take a break from additional large infusions of investment capital. The second issue I would like to make the panel aware of is the tremendous financial pressure that our industry faces. As we purchase grain from our farmer customers, we hedge those purchases in the futures markets. The financial stress to finance inventory purchases from farmers and to

meet the demands of margin calls from our hedges in the futures markets has been overwhelming.

Because they are unable to adequately manage the risk or unable to obtain financing, some firms in our industry have been forced to restrict or eliminate deferred purchases from farmers. If the situation worsens in the months ahead, and this is a very real possibility, meaning if we have price gains and volatility due to weather or other reasons this financial stress will increase. A continued influx of long-only, passively managed investment capital will only make that worse. If that happens, our farmer customers may find continued lack of access to cash forward contracts that they have come to rely upon in managing their price risk simply because our industry does not have the wherewithal to continue to finance our margin calls and hedges.

These problems are important and they are complex. The NGFA has worked diligently with futures exchanges and the CFTC to proactively deal with these issues. First, we have called upon the CFTC to put a moratorium on hedge exemptions for long-only, passively managed investment capital. Second, early last year the CFTC began publication of a supplemental report to its commitment of traders report that attempts to identify investment capital into a new index category. We believe that today's complex environment calls for re-examination of the report in a manner that provides more transparency. We have requested the CFTC to analyze in detail the reporting it receives from market participants to determine if long-only investment capital is reflected in the proper categories.

I thank you for the opportunity to share my thoughts and those of the National Grain and Feed Association with the Subcommittee on these important topics. We want to be a proactive partner with the exchanges, the CFTC, and with Congress to find solutions to the problems that we face. I will be happy to respond to any questions. Thank you.

[The prepared statement of Mr. Clark follows:]

National Grain and Feed Association

Testimony of the
National Grain and Feed Association
to the
Subcommittee on General Farm Commodities and Risk Management
Committee on Agriculture
U.S. House of Representatives

May 15, 2008

Thank you, Mr. Chairman, and Mr. Moran, for calling today's hearing to examine activity in agricultural futures markets, and impacts of market fundamentals and investment capital. The National Grain and Feed Association (NGFA) appreciates the opportunity to provide input on this very important subject.

I am Rod Clark, Vice President of CGB/Diversified Services in Mt. Vernon, Ind. Diversified Services is the farm services and risk management division of CGB, which originates and markets grain and oilseeds for export and domestic channels. CGB has an extensive network of over 60 grain elevators and terminals which utilize various modes of transportation. We have been helping farmers manage their two most significant risks – price and yield – for years. At Diversified Services, our grain marketing experts work with farmers to develop disciplined and localized marketing plans and our crop insurance specialists understand the benefit of tying that marketing plan to a sound yield assurance program.

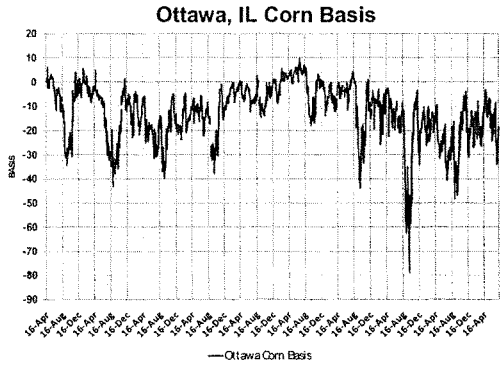
I appear today representing the National Grain and Feed Association. I serve as Chairman of the NGFA's Risk Management Committee, which works to ensure the continuation of efficient, viable and sound agricultural commodity cash and futures markets. The NGFA is comprised of about 900 companies nationwide, including grain elevators, feed manufacturers, oilseed processors, flour mills, biofuels producers and marketers and many other related commercial businesses.

Convergence and Basis Issues

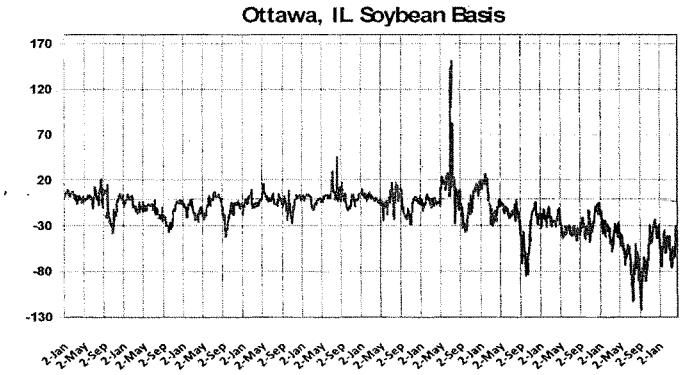
The NGFA's member firms have relied for years on U.S. agricultural futures markets to hedge their price and inventory risk, and to aid them in assisting producers to market their commodities and manage risk. As first-purchasers of grains and oilseeds from producers, these firms rely on well-functioning futures markets for price discovery and risk management. One of the bedrock fundamentals on which hedging strategies are predicated is consistent and reliable convergence between cash and futures prices during the delivery period.

1250 Eye St., N.W., Suite 1003, Washington, D.C. 20005-3922
Phone: (202) 289-0873, FAX: (202) 289-5388, E-Mail: ngfa@ngfa.org, Web Site: http://www.ngfa.org

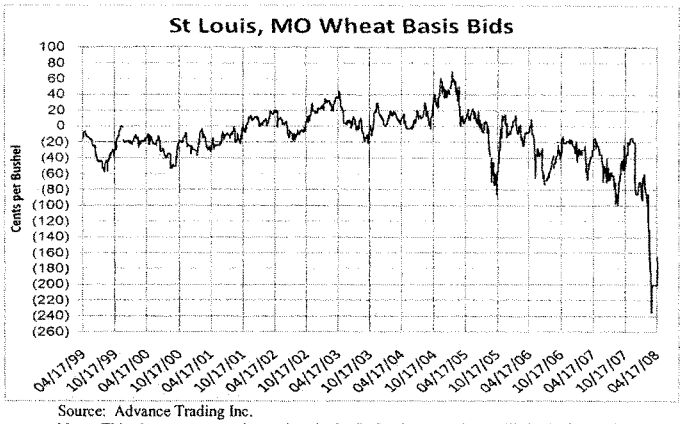
Today, that previously reliable relationship between cash and futures has deteriorated to a point where many commercial grain hedgers are questioning the effectiveness of hedging using exchange-traded futures. Genuine convergence occurs less often and only for short periods of time. The band, or range, of convergence has widened due to several factors, including: 1) higher and more volatile transportation costs; 2) demand for storage created by biofuels growth; and 3) the futures market running ahead of cash values due to the infusion of passively managed, long-only investment capital. The following charts illustrate that basis has become more volatile and "weaker" than demonstrated historically – corn, to some extent, and soybeans and wheat more dramatically – thus, convergence has deteriorated:



Source: Advance Trading Inc.



Source: Advance Trading Inc.



Source: Advance Trading Inc.
Note: This chart represents river values in the St. Louis area; wheat mills in the St. Louis area are paying higher values (e.g., +5 Chicago on one recent day) for appropriate-quality wheat.

This lack of convergence – or "divergence" as some are calling it – is evident in wider basis levels between cash and futures. Cash bids to producers at any given location and time still reflect the true value of commodities, but rapid advances in futures price levels have widened basis to levels not historically expected. This wider basis can sometimes make commodity prices appear "too cheap" at the local grain elevator.

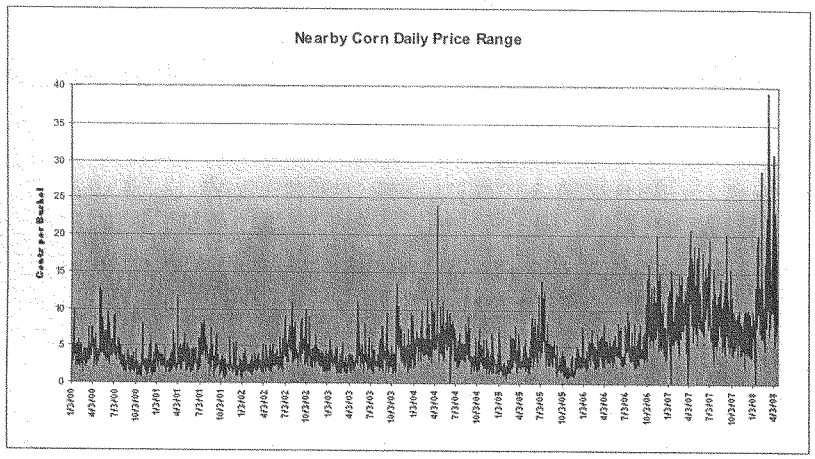
As mentioned above, many factors are at work to influence price levels and basis: transportation and fuel costs; changes in supply/demand fundamentals; carry-over inventory levels; farmer selling; storage rates; and more. Changes in any of these factors can result in significant changes to basis levels, and today we are seeing many changes occurring simultaneously. However, we believe that one new factor – the entry of large amounts of long-only, passively-managed investment capital like index and pension funds into agricultural futures markets – is causing a disruption in markets and resulting in futures prices no longer reflecting true supply/demand fundamentals.

Financial Liquidity Issues

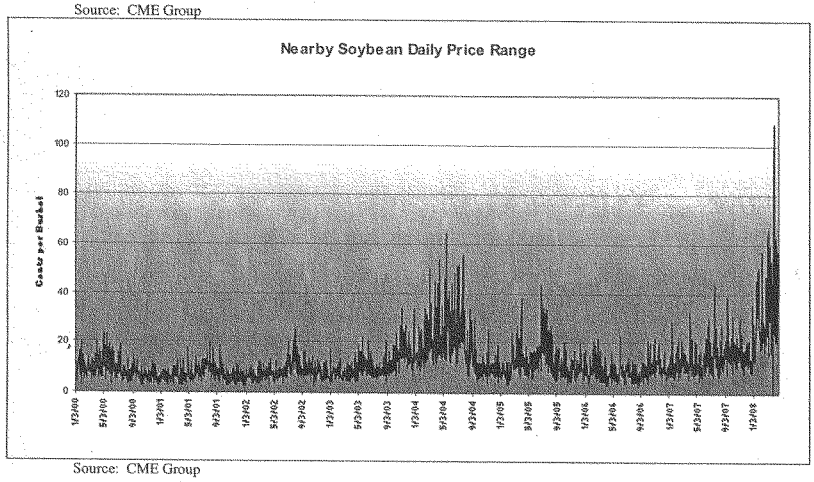
Decreased hedging efficiency due to deteriorating convergence and unpredictable basis patterns are not the only concerns for commercial grain hedgers today. As a result of significantly higher futures prices, driven in part by investment capital, elevators that purchase cash grain from farmers for deferred delivery have been hit with extremely large margin calls on their hedge accounts.

Long-only, passively-managed investment funds account for a significant share of open interest in the CBOT grains and oilseeds contracts. These passively-managed, long-only contracts are not for sale at any price for extended periods of time, resulting in elevated prices not reflective of demand, increased speculative interest in the market, increased volatility, and pressure on banking resources to fund margins.

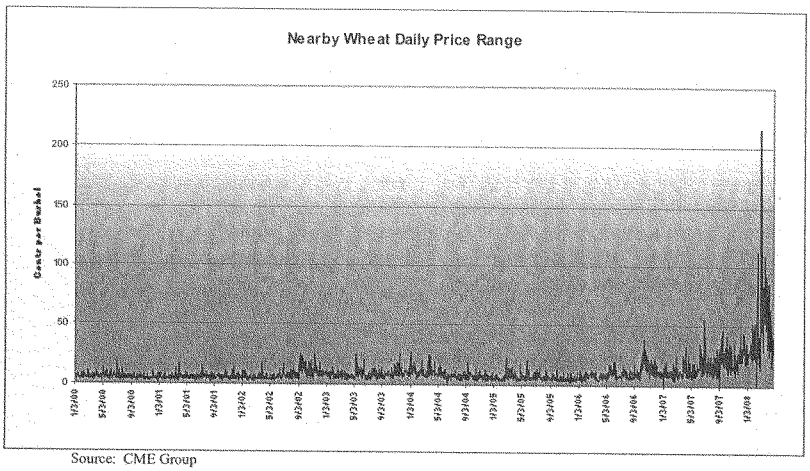
The following charts show the increased volatility for corn, soybean and wheat futures in recent months:



Source: CME Group



Source: CME Group



Source: CME Group

To finance inventory purchases and make margin calls, commercial grain hedgers' borrowing needs today are several times normal levels. Elevators have reached their borrowing limits and some lenders have reached the limit of amounts they can lend to the commercial grain sector. Additional futures price advances – due to supply/demand shocks, bad weather, or ever-larger amounts of investment capital – could lead to severe financial stress. Even today, some elevators lack the capital to finance additional hedges, so they have been forced to restrict or eliminate deferred purchase bids to producers. If the situation continues, producers who lack access to cash forward contracts they have come to expect will increasingly be frustrated when attempting to optimize their marketing opportunities at a time when cash prices are very attractive.

To sum up and quantify the impact of investment capital on agricultural futures markets, we have analyzed the Commodity Futures Trading Commission's (CFTC) Commitment of Traders (COT) report. This particular analysis uses data from the COT report dated April 8, 2008. For this analysis, we have excluded the non-commercial spread positions, which tend to overstate the open interest that is available for purchase or sale. This analysis demonstrates the significant share of open interest held by "Index" traders: 30% of net open interest in corn, 34% in soybeans, and an amazing 50% in wheat. These very large, long-only positions represent a large share of grains and oilseeds volume that is taken off the market for long periods of time and is not for sale at any price!

There is a perception that higher volume leads to increased liquidity. However, such a large share of open interest owned by passive participants actually results in reduced liquidity and higher volatility. In addition to the changes in liquidity and volatility, we believe long-only, passively-managed investment has a significant impact on futures prices and on the process of convergence.

Moratorium on Hedge Exemptions

For the reasons detailed above, the NGFA opposed proposals by the Commodity Futures Trading Commission (CFTC) late last year to increase federal speculative position limits and to create a new hedge exemption for index and pension funds. Today, we believe action by the CFTC is urgently needed to allow agricultural markets to "take a break" and adjust before additional large amounts of investment capital find their way into agricultural futures. At the CFTC's Agricultural Futures Roundtable on April 22, we shared with the Commission our belief that investment capital is having a significant impact in agricultural futures markets.

Consequently, the NGFA has petitioned the CFTC for a **moratorium on all hedge exemptions for long-only, passively-managed investment capital entering agricultural futures markets.** For the two funds already approved by CFTC for hedge exemptions, the NGFA has asked the Commission not to expand their hedge exemptions beyond levels already approved by the Commission. The NGFA also has recommended that long-only, passively-managed investment capital participate in futures on a dollar-for-dollar, unleveraged basis – that is, that a participant's positions in agricultural futures contracts should be backed by an identical amount of investor funds held in an account by the fund.

Commitments of Traders Report

Early last year, the CFTC began publication of a supplemental COT report with a new "Index" category to report investment capital. The NGFA's member companies were extremely pleased with that new category, believing that transparency in the marketplace is of benefit to all participants. In particular, the new "Index" category was helpful in assisting commercial grain hedgers to develop their risk management strategies based on supply/demand fundamentals, rather than on speculative investment capital.

We believe that today's market environment calls for a re-examination of the CoT report. While some suggest that investment capital's share of open interest in agricultural futures contracts has not increased in recent years, we are skeptical of that claim. We suspect that some activity that rightly belongs in the "Index" category could now be showing up in other CoT report categories. For that reason, **we have requested that the CFTC analyze in detail the reporting it receives from market participants to determine if all long-only investment capital is reflected in the "Index" category.** Additionally, we have asked CFTC to fully and clearly define futures market activity reported in each existing category of the report; and consider whether any additional detail/categories added to the report would provide additional clarity for market participants.

Summary

Ultimately, the solution to recent market upheaval may simply be time. In time, the market may respond to new realities. The market likely will create new ways to deploy capital in agriculture. In time, industry may expand storage, and the CME Group may implement enhancements to their contracts. Without a doubt, market participants will create new products for risk management that reflect the broad changes in the agricultural landscape – transportation, biofuels, major acreage shifts, to name a few. The NGFA will continue its work to identify additional potential responses to assist commercial grain hedgers dealing with the volatility and financial stresses of today's markets, whether they be changes to futures contracts, regulatory action or some other course.

In the shorter term, there are real disconnects and real stresses, in particular on the commercial grain hedging sector. We believe these stresses call for action along the lines outlined above that will help build a bridge to new market realities. Failing to do so could have serious consequences for all sectors of agriculture, including producers and the elevators who work with them to facilitate efficient marketing and risk management for the grain sector.

Again, Mr. Chairman, the NGFA deeply appreciates the opportunity to share our thoughts with the subcommittee. I would be happy to respond to any questions.

The CHAIRMAN. Thank you, Mr. Clark. Mr. Farley, 5 minutes.

STATEMENT OF THOMAS FARLEY, PRESIDENT AND COO, ICE FUTURES U.S., NEW YORK, NY

Mr. FARLEY. Thank you, Mr. Chairman. I am Thomas Farley, President and COO of ICE Futures U.S., and I appreciate the opportunity to testify before the Subcommittee today on recent trends in the futures markets. ICE Futures U.S., formerly known as the New York Board of Trade, or NYBOT, was founded in 1870 and is a wholly-owned subsidiary of IntercontinentalExchange known as ICE, an Atlanta based public company that operates regulated futures exchanges and clearinghouses in the United States, United Kingdom, and Canada, as well as an over-the-counter marketplace. ICE Futures U.S. is the leading futures exchange for sugar, coffee, cocoa, cotton, and orange juice, and also lists currency and equity index futures contracts.

Many of the products traded on our exchange and other exchanges have experienced dramatic price movements over the last several months and quarters. During periods of high prices and volatility, it may be a natural reaction to focus on exchanges. It is important to bear in mind that while we are the messengers of price information the prices that are discovered on our exchanges are the result of market-based activity. As such, we encourage a broader objective review of today's unusual environment. Recent dramatic movements are not isolated to our markets but have been seen across agricultural, metals, equity, energy, and interest rate markets.

Comparing the historic volatility for a dozen equity, interest rate, energy, and agricultural markets traded on our exchange and elsewhere, we found that volatility in all of these markets for the month of March 2008 was between 1.4 to 3.1 times higher than March of 2007. Further, we did not find the increase in agricultural markets to be any more pronounced than the increase in the these other markets. Nearly all global markets are experiencing increased volatility. Therefore, prescriptive measures intended to reduce volatility in a given market or across multiple markets will likely be negated by the existence of broader market turbulence and have unintended negative consequences. Worldwide commodity prices are moving in ways that defy conventional models constructed to produce price movements. With respect to agricultural commodities, I would like to share three factors that are impacting price levels.

First, China, India, and other emerging economies are increasing consumption of raw commodities at an unprecedented rate taking global demand to new levels. Second, the dollar is at all time lows compared to many foreign currencies making it less expensive for global citizens to consume these goods. And, third, corn-based ethanol incentives and sugar-based ethanol tariffs here in the United States mean that over ⅓ of our corn crop is now consumed in the production of corn-based ethanol. This demand has triggered a domino effect where the competition for acreage has contributed to record price levels of many agricultural products. One factor that some have suggested may be affecting volatility on futures exchanges is the role of so-called long-only commodity index funds.

The complete analysis of the potential impact of such funds is still in process but our findings indicate that commodity index funds have had a positive impact on our agricultural markets as they enable producers, their cooperatives, and merchants to manage risk on a greater portion of their production. As a general rule, in the cotton market as well as our other agricultural markets the producers and merchants are sellers that use futures to protect or hedge against decreases in prices. Long-only index funds, whether you label them investors or speculators, fulfill an important role as they are buyers that take the other side of the producers and merchants futures transactions.

While the involvement of long-only funds in the cotton market has been under particular scrutiny in the past several weeks. It is interesting to note that using a common measure of market participation the proportion of cotton futures and options long open interest attributable to such funds, their participation has actually decreased over the last 2 years. Looking at March of each year, the figure has gone from 37 percent to 34 percent to 23 percent in March of 2008. I would like to briefly address the role of clearinghouses as well as the importance of futures style margining in managing systemic risks. Our clearinghouse, ICE Clear U.S., has its own governing board and rules subject to the regulation of the CFTC, much like our exchange.

Each day, the clearinghouse marks the positions carried by each clearing member to the market based upon the closing or settlement price for each individual futures contract. The clearinghouse collects cash from the clearing firms who had a net loss on the prior day, and it pays that cash to the clearing firms who generated a net profit. These amounts are referred to as variation margins. To guarantee its obligation to make variation margin payments when due each clearing member makes a security deposit called initial margin. Initial margin and variation margin are designed to ensure that the clearinghouse has sufficient funds to cover its obligations even in highly volatile markets. Margin is not intended to control price volatility or the amount of trading at a particular market. Rather, it is the key element that protects the financial integrity of our markets.

Attempting to employ margin payments for purposes other than risk management would be unprecedented and undermine a business model that has been a shining star in the financial markets for 150 years. Mr. Chairman, thank you again for inviting me to testify on behalf of the exchange.

[The prepared statement of Mr. Farley follows:]

ICE Atlanta Calgary Chicago Houston London New York Singapore

WRITTEN TESTIMONY OF THOMAS FARLEY, PRESIDENT & COO

ICE FUTURES U.S.

NEW YORK, NY

Before the

SUBCOMMITTEE ON GENERAL FARM COMMODITIES

AND RISK MANAGEMENT

of the

COMMITTEE ON AGRICULTURE

U.S. HOUSE OF REPRESENTATAIVES

on May 15, 2008

Mr. Chairman, I am Thomas Farley, President and COO of ICE Futures U.S., and I appreciate the opportunity to testify before the Subcommittee today on recent trends in the futures markets. ICE Futures U.S., formerly known as the New York Board of Trade, is a wholly-owned subsidiary of IntercontinentalExchange ("ICE"), an Atlanta-based public company that operates regulated futures exchanges and clearinghouses in the United States, the United Kingdom, and Canada, as well as an over-the-counter marketplace.

ICE Futures U.S., which is regulated by the Commodity Futures Trading Commission (the "Commission" or "CFTC") is the leading futures exchange for sugar, coffee, cocoa, cotton, and orange juice, and also lists currency and equity index futures contracts. Many of the products traded on our Exchange, and other exchanges, have experienced dramatic price movements over the past several months – both large directional moves and increased volatility. As an exchange, we serve as a neutral venue for price discovery for critically-important commodities that enables market participants to manage risk and respond to price signals. During periods of high prices and volatility, it may be a natural reaction to focus on exchanges. It is important to bear in mind that while we are the messengers of price information, these prices are the result of market-based activity. As such, we encourage a broader, objective review of today's unusual environment.

Recent dramatic movements are not isolated to our markets, but have been seen across agricultural, metals, equity, energy and financial markets. Comparing the historic volatility for a dozen equity, interest rate, energy and agricultural markets, traded on our exchange and others, we found that volatility in all of these markets for the month of March 2008 was 1.4 to 3.1 times higher than volatility for the month of March 2007.

Further, we did not find the increase in agricultural markets to be any more pronounced than the increase in these other markets. Nearly all global markets, whether traded on- or off-exchange, are experiencing increased volatility. Therefore, prescriptive measures intended to reduce volatility in a given market or across multiple markets will likely be negated by the existence of broader market turbulence and have unintended negative consequences.

Worldwide commodity prices are moving in ways that defy conventional models constructed to predict price movements. With respect to agricultural commodities, it may be straightforward to identify contributing factors, but it is impossible to ascertain the precise impact of each individual factor on prices. China, India and other emerging economies are increasing consumption of energy, food and fiber products at an unprecedented rate, taking global demand to new levels. Drought and low yields in the key growing areas, as well as hoarding, tariffs and export controls, have contributed to supply shortages. The dollar is at all-time lows compared to many foreign currencies, making it less expensive for global citizens to consume these goods. Corn-based ethanol incentives and sugar-based ethanol tariffs in the United States mean that over one-third of our corn crop will likely be consumed in the production of corn-based ethanol. These demands have triggered a domino effect where the competition for acreage among other domestic agricultural products, including cotton, corn, soybeans and wheat, has contributed to record price levels of all of these products.

One factor that some have suggested may be affecting volatility on futures exchanges is the role of "long-only" commodity index funds. The complete analysis of the potential impact of such funds is still in-process, but our preliminary findings indicate that commodity-index funds have had a positive impact on our agricultural markets, as they enable producers, their cooperatives, and merchants to manage risk on a greater portion of their production.

As a general rule, in the cotton market the producers and merchants are sellers that use futures to protect or "hedge" against decreases in prices. In order to hedge this price risk there must be a sufficient number of active traders on the opposite side of the market who want to buy, or "go long", the futures contract. Long-only index funds, whether you label them investors or speculators, fulfill an important role, as they are buyers that take the other side of the producers' and merchants' futures transactions. Furthermore, enabling long-only funds to transact in an organized public market maintains the price transparency needed to attract additional capital into these underlying commodity markets. While the involvement of long-only funds in the cotton market has been under particular scrutiny in recent weeks, it is interesting to note that the proportion of cotton futures and options long open interest (a common measure of market participation) attributable to long-only funds has actually decreased over the past two years, despite the heightened volatility and price spikes the cotton markets have experienced: it was 36.9% in March 2006, 33.7% in March 2007 and 22.5% in March 2008.

I would like to briefly address the role of exchanges and clearinghouses as well as the importance of futures-style margining in managing systemic risks. This model of risk

management – or clearing – has been a shining star in the financial markets for close to 150 years, managing turbulent periods - similar to what we have experienced in recent months - many times over.

I will discuss our cotton markets as an example of how we run our Exchange and interact with market participants. One of our Exchange's predecessors, the New York Cotton Exchange, was founded 138 years ago, in 1870. Today, the Exchange continues to ensure that the cotton futures and options contracts remain viable hedging mechanisms by consulting with the cotton trade on the terms and conditions of the contracts. Moreover, we strive to ensure that that our markets evolve while remaining in compliance with the Commodity Exchange Act and CFTC regulations, establishing rules that assure fair and transparent price discovery. At ICE Futures U.S., our cotton committee provides guidance so that our markets meet the needs of commercial users. The committee is made up of 20 cotton market participants, many of whom are leaders of the industry.

Clearinghouses play a pivotal role in the risk management offerings of an exchange. Our clearinghouse, ICE Clear U.S., is a wholly-owned subsidiary of the Exchange and its purpose is to act as a financial counterparty to every trade while preserving the financial integrity of our marketplace. The clearinghouse deals exclusively with the firms that are its members, and all transactions executed on the Exchange are cleared through such a clearing member. ICE Clear U.S. has its own governing board and rules subject to the regulation of the CFTC. Each day, the clearinghouse marks the cotton positions carried by each clearing member to the market based upon the closing or "settlement price" of the cotton futures contract. The clearinghouse collects cash from the clearing firms who had a net loss on the prior day and pays that cash to the clearing firms who generated a net profit on the prior day. These amounts are referred to as "variation margin". To guarantee its obligation to make variation margin payments when due, each clearing member makes a security deposit called "initial margin". The rules governing initial margin and variation margin are designed to ensure that the clearinghouse has sufficient funds to cover its obligations to the clearing members that are the counterparty to each cleared trade, even in highly volatile markets.

Margin is not intended, by law or in practice, to control price volatility or the amount of trading in a particular market; rather, it is the key element that protects the financial integrity of the markets. Attempting to employ margin levels and requirements for purposes other than risk management would be unprecedented and undermine a model that has successfully provided a critical credit function in this country for 150 years.

Attempts at price control -- whether by increasing margins arbitrarily rather than based on market fundamentals; by restricting participation in the markets; or by other strategies to limit market activity -- have always failed. In recent months, India banned futures trading in a number of agricultural products that were experiencing rising prices and volatility, despite the lack of evidence of price manipulation. Rather than lowering prices, that restrictive move simply added price uncertainty and opacity since it eliminated an organized market in which prices could be widely discovered and disseminated. In a similar move, many other countries in addition to India recently

placed export controls on agricultural commodities, which only confounded the supply problem in already stressed global markets.

Worldwide concern about prices and short supplies is indeed justified. In this climate it is important to avoid actions that could ultimately make the marketplace less transparent and more volatile. ICE Futures U.S., and no doubt other exchanges, is working overtime to monitor events, to liaise with the CFTC, to observe markets and participants, and to review current practices to analyze where modifications may be appropriate. As an exchange, it is in our best interest to engender confidence in our marketplace. Importantly, the CFTC, exchanges and the broader trading community must continue to work together to monitor and to respond appropriately to these evolving, dynamic and global markets.

Mr. Chairman, thank you again for inviting me to testify on behalf of the Exchange. I would be pleased to answer any questions you or other Members of the Subcommittee may have.

The CHAIRMAN. Thank you, Mr. Farley. Mr. Weil, for 5 minutes.

STATEMENT OF ADOLPH "ANDY" WEIL III, PRESIDENT, AMERICAN COTTON SHIPPERS ASSOCIATION; MEMBER, EXECUTIVE COMMITTEE, NATIONAL COTTON COUNCIL, MONTGOMERY, AL

Mr. WEIL. Thank you, Mr. Chairman. I am Andy Weil of Montgomery, Alabama, President of the American Cotton Shippers Association. I am also a Member of the Executive Committee of the National Cotton Council. With me today are other ACSA officials, Gerry Marshall, John Dunavant, and Neal Gillen. First of all, we thank you for holding and conducting this hearing today. Today I speak for the entire cotton industry, which was devastated by the disruptive and excessive speculative activity of March 3 and 4, and has yet to fully recover from its adverse effects. My written statement fully details what occurred in the cotton market in mid-February to early March. Now I will tell you in brief what occurred and why the U.S. cotton industry and its supporting financial institutions lack confidence in the ICE No. 2 Futures Contract as a vehicle to manage our price risks through hedging and to seek price discovery.

By early March the open interest had reached record levels of just over 300,000 contracts for 30 million bales of cotton. About ⅔ of this open interest was in the May and July contract periods, while the other third was in the December contract month. Since the U.S. provided only 19 million bales in 2007 the commercial trade represented a much smaller portion of this volume. The commercials who held the physical cotton had sold futures to lock in their basis and carry the cotton until sold and shipped. Speculative trading drove up cotton futures prices by over 50 percent in a 2 week trading period in late February and early March. On March 3, while futures prices was up the limit of 3¢ per pound the price rose to 93.9¢, up 12¢ that day.

It was at this level of 93.9¢ where daily variation margins were set for collection. This resulted in a collective margin call on the industry that day well in excess of $1 billion. As a result of this unprecedented financial stress, the following morning many traders were forced to liquidate their hedges by their lenders. This buying pushed prices to $1.09, only the second time since the Civil War that cotton has traded over $1.00. At the same time, the physical price was in the low 60¢ range. In the short time frame that day, the commercial trade did not have sufficient time to adjust to this irrational event, which was unrelated to the physical or cash market. The commercial market was subject to a severe financial strain never realized before in the history of the U.S. cotton industry.

To meet margin calls, banks would have had to evaluate clients' physical stocks well beyond what the market could bear. The value of the cash commodity bore no relationship to the futures or options prices. The current futures market situation precludes any form of price discovery because of the potentially high margin risks. The result is that merchants and cooperatives cannot offer farmers forward prices. This situation also precludes individual farmers from using the futures market. Therefore, the producer cannot take a forward contract to his banker to secure financing.

This is not only true for cotton but for other agricultural commodities. As a result, the banks financing producers, merchants, and cooperatives no longer have confidence in the futures market. Now they are either reluctant to or lack the capacity to provide the necessary margin funding.

Lacking price discovery, the U.S. cotton farmer cannot adequately make production plans. The same goes for a U.S. textile mill who cannot determine what his raw fiber costs will be in future months. The entry of large speculative funds and index funds into the agricultural futures contracts has clearly distorted both the futures and the physical or cash markets and agricultural commodities. There is such an abundance of cash in the hands of these funds that their impact on the agricultural markets is overwhelming and negates the primary purpose for the existence of such contract markets. We no longer have a rational market for price discovery and hedging as used to the commercial trade has been minimized.

It is not an investment vehicle for huge speculative funds and swaps dealers and other OTC entities that have created havoc in the market unimpeded by fundamentals or regulation. More importantly, there is no limit to or transparency in the trading activity. Therefore, I suggest that these unregulated entities be subject to the same reporting requirements that I as a legitimate hedger am subjected to by requiring that they report their full position to the CFTC each week. In conclusion, what we have learned from this bitter experience is that the CFTC does not know what is going on in the markets; who is doing the trading; how much they are trading; and in what markets. In point of fact, neither does the Federal Reserve, the Treasury Department, the SEC, or any other U.S. Government agency know what is going on.

In sum and substance, Mr. Chairman, let us find out who they are and what they are doing. Accordingly, we believe that our recommendations if implemented by the CFTC will help to restore confidence in the agricultural futures markets. In the interest of time, Mr. Chairman, I can go ahead and read our recommendations, if that is okay.

The CHAIRMAN. That would be fine.

Mr. WEIL. Okay. Thank you. Require that an index fund with a hedge exemption restrict its position in a commodity to the dollar allocation or the percentage of funds allocated to that commodity as defined in the funds prospectus and recorded with the CFTC. Further, any variation should be subject to the speculative position limits, and that such funds should report their cash positions on a weekly basis. Recommend that the CFTC monitor and oversee all swaps and OTC activity by requiring the reporting of all swap and OTC contracts by market participants, and that the CFTC determine the aggregation of positions from all sources, including the exchanges, ETFs, swaps, OTC, and all other trading entities.

Require that all non-traditional hedge accounts, those not involved in the commercial enterprise of physically trading bales of cotton, be reported as a separate individual category. Require that the ICE and its clearing members adhere to the practice of margining futures to futures settlements and option to option settlements, that only those involved in the commercial enterprise of

physically trading bales of cotton shall be eligible for hedge margin levels. And, finally, urge the CFTC to study the impact on price discovery and volatility, prior to any additional increases above current levels in speculative position limits in the single months or all months. Thank you, Mr. Chairman.

[The prepared statement of Mr. Weil follows:]

Statement
Of
American Cotton Shippers Association
On
Disruptive Trading Activity In Cotton Futures Market
To
General Farm Commodities & Risk Management Subcommittee
Committee on Agriculture
U.S. House of Representatives
May 15, 2008

Chairman Etheridge, Ranking Member Moran, and members of the subcommittee, I am Adolph "Andy" Weil, III of Montgomery, Alabama. I appear today in my capacity as President of the American Cotton Shippers Association (ACSA). I am also a member of the Executive Committee of the National Cotton Council. Accompanying me today is the Chairman of ACSA's Committee on National Affairs – Gerald C. Marshall, ACSA 2nd Vice President - John Dunavant, and our Executive V.P. & General Counsel - Neal P. Gillen.

The concerns and recommendations expressed in this statement pertain to the adverse impact of excessive and disruptive speculation in the Intercontinental Exchange (ICE) No. 2 Cotton Contract on the entirety of the U.S. cotton industry involved in the production, ginning, storage and shipment, marketing, and manufacturing – producers, ginners, warehousemen, merchants, cooperatives, and textile mills.

For the past two months ACSA has been working closely with Amcot – the association of marketing cooperatives, and the American Cotton Producers of the National Cotton Council in addressing our concerns to the ICE, the Commodity Futures Trading Commission (CFTC), and the Congress. We hope that this hearing – the first such hearing by the Congress on this matter – would result in the adoption of measures similar to those we will present today that would provide the necessary transparency, reporting, and oversight, of the unregulated markets creating havoc in the agricultural cash and futures markets.

Interest of ACSA

ACSA, founded in 1924, is composed of primary buyers, mill service agents, merchants, shippers, and exporters of raw cotton, who are members of four federated associations located in sixteen states throughout the cotton belt:

Atlantic Cotton Association (AL, FL, GA, NC, SC, & VA)
Southern Cotton Association (AR, LA, MS, MO, & TN)
Texas Cotton Association (OK & TX)
Western Cotton Shippers Association (AZ, CA, & NM)

ACSA's member firms handle over 80% of the U.S. cotton sold in domestic and export markets. In addition, our members also handle a myriad of foreign growths of cotton, which is forward priced based on the New York futures market. Because of their involvement in the purchase, storage, sale, and shipment of cotton, ACSA members, along with their producer and mill customers, are significant users of the ICE's No. 2 Futures Contract. Therefore, they are vitally interested in a return to an orderly futures market reflecting market fundamentals that are not grossly distorted by speculative interests.

Congress Authorized Futures Trading in Agricultural Commodities for Price Discovery & Hedging

The U.S. Congress authorized contract market designations in the agricultural commodities for the purposes of trading in futures contracts primarily to:

- Hedge against price risks;
- Discover prices through vigorous competition; and
- Price commercial transactions.

The Congress acknowledged that while futures contracts offer an investment opportunity, this conduct should be subordinate in importance to the commercial uses for which the agricultural contract markets were created.

In the discussion that follows, we establish that the market fundamentals bear little relationship to the speculative activity in the ICE Number 2 Cotton Contract. As a result, commercial hedgers have exited this market, due to the fact the traditional cash to futures relationship has ceased to exist.

This situation is the result of a recent phenomena, the advent of index funds with an estimated aggregate value of $1 trillion and the participation of Over-the-Counter (OTC) traders, which take a myriad of forms. While bringing record liquidity to the agricultural contracts, these entities have turned such contracts into investment contracts, thereby defeating the purposes for which said agricultural contracts were created. The result has rendered the agricultural contracts, particularly the cotton contract, ineffective for hedging against price risks, the discovery of prices, and the actual pricing of commercial transactions. The physical markets in the agricultural commodities have been adversely impacted precluding cooperatives and merchants from offering price quotations to farmers or end users since they cannot use the contracts for hedging purposes.

The New Speculative Activity Ignores Market Fundamentals Creating Severe Strain on the Cash Trade Resulting in the Lack of Price Discovery, the Loss of a Hedging Tool, & Higher Margin Costs

Since January, the U.S. cotton industry and its supporting financial institutions have lacked confidence in the ICE Number 2 Cotton Contract as a vehicle to manage its price risks through hedging and to seek price discovery.

By early March, the open interest had reached record levels of just over 300,000 contracts or 30 million bales of cotton. About two thirds of this open interest was in the May and July contract periods, while the other third was in the December contract month. Since the U.S. produced only19 million bales in 2007, the commercial trade (producers, cooperatives, merchants, and mills) represented a much smaller portion of this volume. The commercials that held the physical cotton had sold futures to lock in their basis and carry the cotton until sold and shipped.

This basis was determined when the producer, cooperative or merchant agreed to the physical sale. It is imperative that a traditional hedger be able to hedge by locking in his basis to reduce price risk, and that the market providing the hedge represent the underlying cash market value. It is equally critical to the interest of his or her lender. Banks demand that a client's position be marked-to-market on a daily basis so that they can value the collateral held by the bank in the trader's account.

Speculative trading, at a time when not one additional bale was consumed or destroyed by weather, drove up cotton futures prices by over 50 percent in a two-week trading period in late February. On March 3rd, the price in the front month (March) reached $1.09, when two weeks previous to that it was at 72 cents. At the same time, the physical price was in the low 60 cent range. On that day, in a short time frame, the commercial trade did not have sufficient time to adjust to this irrational event, which was unrelated to the physical or cash market – a market with half of last year's 19 million bale crop still unsold – the highest level of U.S. stocks since 1966 - a market with a 50 percent U.S. and world stocks-to-use ratio given record world yields and reduced consumption due to poor economic conditions.

The commercial trade was subject to an immediate, unwarranted, and severe financial strain – a strain never realized before in the history of the U.S. cotton industry. Credit lines and lender's perceptions of client risk were tested well beyond the norm. To meet margin calls, banks would have had to value a clients' physical stocks well beyond what the market could bear. The value of the cash commodity bore no relationship to the futures or option prices. No potential buyer of the physical commodity, either a textile mill or another merchant, would pay an amount in excess of its spot or cash market value. Therefore, to satisfy its lenders, the commercial trade had to close out futures at huge losses to generate the cash to repay its loans. Some smaller merchants, who could not withstand these losses, were forced to discontinue operations. Larger merchants with

more substantial balance sheets were severely impacted as well and in some cases had to cease or greatly reduce the scope of their operations. At the end of the day, over $1 billion would be posted in margin calls.

The current futures market situation precludes any form of price discovery because of the potentially high margin risks. Lacking the financial ability or willingness to hedge in the futures market, the result is that merchants and cooperatives cannot offer farmers forward prices. This situation also precludes individual farmers from using the futures market.

The private trade and the cooperatives have been forced to change their business models. We can no longer offer producers forward prices. Therefore, the producer cannot take a forward contract to his banker to secure financing. This is not only true for cotton, but for every other agricultural commodity. The banks financing producers, merchants and cooperatives no longer have confidence in the futures market. Therefore, they are reluctant or lack the capacity to provide the necessary margin funding. Like us, our financing banks are still in shock from the massive margin calls in the first week of March.

Lacking price discovery, the U.S. cotton farmer cannot adequately make production plans. The same goes for a U.S. textile mill who cannot determine what his raw fiber costs will be in future months. Further, this situation has severely impacted foreign producers, particularly in Australia and Brazil who use the ICE Contract to price forward contracts up to two years in advance of planting.

The entry of large speculative funds and index funds into the agricultural futures contracts has clearly distorted both the futures and the physical or cash markets in agricultural commodities. There is such an abundance of cash in the hands of these funds that their impact on the agricultural markets is overwhelming and negates the primary purposes for the existence of such contract markets.

Re-examine Hedge Exemption for Index Funds Not Involved In Agricultural Markets

Lacking confidence in price discovery, the U.S. cotton industry and some of the world's leading producers are now at a virtual standstill.[1] The U.S. cotton trade has

[1] In normal times of abundant supply, futures will trade at full carry from the first to the second futures month. "Full carry" in this context is for the certificated stock – cotton eligible for delivery on the futures contract as distinguished from regular cotton inventory. The difference between the two is the weight and overage penalties that accrue on certificated stock as it remains under certification for extended time periods. For cotton under certification between four and twelve months, these penalties amount to 3.5 lbs of weight per bale per month. So if, for example, a trader were to take delivery of this cotton in May and re-tender the bales on July futures, he would invoice each bale in July at seven pounds less than he paid for it in May. This seven pounds amounts to just over $5 per bale at current prices (7 lbs @ .73 equals 5.11). This

successfully utilized the cotton futures contract as the foundation for its business model for over 135 years. Overnight, we have been stripped of a vital tool in which to conduct our business. We are now exposed to greater risk, which allows only the few highly financed or leveraged companies to function.

Unregulated speculation has severely limited our role of making a market for our producer and mill customers. In the future, how can producers maximize their price at the farm gate or textile mills minimize their costs at the receiving dock lacking a futures market that provides accurate price discovery?

We simply cannot function in a market with unrestrained volatility unrelated to supply-demand conditions or weather events. The ICE Number 2 Contract is no longer a rational market for price discovery and hedging – its use to the commercial trade has been minimized. It is now an investment vehicle for huge speculative funds that have created havoc in the market unimpeded by fundamentals or regulation. It is a market overrun by cash precluding convergence of cash and futures prices, hedging, and forward contracting – a market lacking an economic purpose – a market not contemplated by the Congress when it authorized futures trading of agricultural commodities.

While speculative interests are vital to the functioning of a futures contract, a balance must be struck. In that regard, the CFTC is urged to take the necessary and immediate action to bring this about and restore the commercial trade's confidence in the futures market. Therefore, **we recommend that an index fund with a hedge exemption**

---

needs to be added to the cost of carry on regular inventory. Regular carry amounts to about $5.50 per bale per month in a Memphis warehouse (Memphis is where the bulk of the current cert stock is stored). To summarize, the cost of carrying cert stock for two months from May to July amounts to about $16.10 per bale ($5.11 penalty + two months carry @ $5.50). This amounts to 322 points at 500 pounds per bale.

Between May 1 and July 1 there will be 600,000 bales of certificated stock with an age of four months or older. This is roughly 60 percent of the 1 million bales in the cert stock. This means the weighted cost of carrying the entire cert stock from May to July is 290 points (600,000 bales @322 and 400,000 bales @ 243). In theory, then, 290 points is the maximum spread that May should trade under July, since that is sufficient discount to ensure a risk-less transaction, buying May and selling July. "Risk-less," that is, except for the cash flow risk of owning over one million bales hedged with short July futures for two months! In the event the cotton market should repeat its recent performance and spike say thirty cents per pound, the owner of the cert stock would need to come up with an additional $150 million to meet margin calls before he could liquidate his seemingly "risk-free" trade. Few if any members of the cotton trade are in position to take this cash flow risk. This was recently reflected in the 360-point spread at which May/July was trading.

The additional 70 points over the cost of carrying the position for two months reflected the trade's unwillingness (or inability) to take this cash flow risk. In normal times, merchants would have tripped over each other to lock in such a margin, yet the market has traded at this level. In fact, far from rushing to lock in this margin, merchants continue to add additional bales to the cert stock, presumably to get the cotton off the balance sheet along with the accompanying short futures. This implies extraordinary levels of risk aversion, and a failure of the market to provide accurate price discovery.

should restrict its position in a commodity to the dollar allocation or the percentage of funds allocated to that commodity as defined in its prospectus and recorded with the CFTC. Further, any variation should be subject to speculative position limits, and that such funds should report their cash positions on a weekly basis.

We also submit that the role of the unregulated swaps market is contributing to this situation since there is no limit to or transparency in their trading activity. It is our recommendation **that the CFTC be mandated to monitor and oversee all swaps and OTC activity by requiring the reporting of all swap and OTC contracts by market participants, and that it determine the aggregation of positions from all sources, including the exchanges, ETFs, swaps, OTC, and all other trading entities. Further, that all non-traditional hedge accounts, those not involved in the commercial enterprise of physically trading bales of cotton, be reported as a separate individual category.**

Cotton Margin Requirements Are Arbitrary & Onerous

The role of margin requirements should insure the efficient operation of a contract market by maintaining a balance of accounts between the longs and shorts and when necessary by requiring additional margin calls to effect orderly settlement in volatile markets. Most importantly, margin requirements should be fair, consistent, and facilitate the efficient functioning of a contract market. That is not the case with cotton margin requirements.

The margin requirement in the ICE Number 2 Cotton Contract is arbitrary, capricious, and unreasonable. The cotton contract does not margin futures to the close of the futures contract month, but establishes margins at the synthetic level determined by the close of the options contract in that month. While the futures month may be locked at the limit there are no limits on the option's contract, therefore, in that situation the option is likely to close at a level well above the futures close. This onerous requirement limits the ability of the commercial trade to obtain the requisite financing to use the contract market, thereby precluding the use of the contract market for price discovery and hedging.

While the margins are established by the contract markets and do not require approval of the CFTC, the CFTC does have emergency authority under Section 12a(9) of the Commodity Exchange Act[2] "to direct the contract market whenever it has reason to believe that an emergency exists, to take such action as, in the Commission's judgment, is necessary to maintain or restore orderly trading in ... any contract market." The current situation is such an emergency pursuant to the statutory definition as it constitutes a "major market disturbance which prevents the market from accurately reflecting the

[2] 7 USC 12a(9)

forces of supply and demand for such commodity."[3] In this case cotton. Such an emergency exists, and we urge the Congress to compel the Commission to use it emergency authority to, inter alia, **require that the ICE and its clearing members adhere to the practice of margining futures to futures settlements and options to option settlements and that only those involved in the physical handling of the agricultural commodity (cotton) be eligible for hedge margin levels.**

The Congress Must Act To Restore Historic Equilibrium To Agricultural Futures Markets, Thereby Enabling Participants To Seek Accurate Price Discovery & To Use For Risk Management Hedging Purposes

For too many years, we have heard the argument that the unregulated markets are passive. That they have no impact on the workings of the agricultural futures contract markets. That might have been true at one time, but that is not the case today. They now have found a home in the agricultural markets, and they, not the market fundamentals are controlling these markets. You cannot ignore that fact. Now they dominate and distort our markets. Accordingly, you must act or American agriculture will suffer the consequences of inaction.

We urge the Congress to take the appropriate, prompt, and necessary action that would bring transparency to the cotton contract and all the agricultural contracts, limit excessive and disruptive speculation unrelated to market fundamentals, restore price discovery, and encourage the commercial trade to utilize the contract as a hedging mechanism thereby allowing producers and textile mills to once again have access to forward contracts as risk management tools.

In doing so, we respectfully suggest that the Congress be firm in its resolve and that it ignore those who would justify this irrational imbalance in the U.S. agricultural contract markets on the grounds that the necessary oversight, reporting, and regulation of the index funds and swaps operators would drive this business offshore. That is a competition issue that should be resolved in the international marketplace. It is not the role of the Congress or the CFTC to guarantee the exchanges record trading volumes, but to assure that the agricultural contracts provide price discovery and hedging. The Congress and the CFTC's role is to protect those that Congress intended it to protect - the commercial users of the agricultural contract markets.

By taking action to restore the integrity of the agricultural contract markets the Congress would assure that the CFTC fulfills the legislative intent of its role as an independent regulatory agency to prevent "excessive speculation ... to the detriment of the producer or the consumer and the persons handling commodities and the products and

---

[3] Id.

byproducts thereof in interstate commerce rendering regulation imperative for the protection of such commerce and the national public interest therein."[4]

ACSA supported the establishment of the CFTC as an independent regulatory agency in 1974. It continues to support the CFTC, and it urges the Congress to provide the CFTC with the necessary mandates and resources to fulfill its statutory duty and resolve the current crisis in the agricultural contract markets.

I thank you for the opportunity to express these views on behalf of the cotton industry. I will be happy to respond to any questions you may address to me or those accompanying me today.

---

[4] 7 USC 5

RECOMMENDATIONS

RESTRICTIONS ON SPECULATIVE ACTIVITY OF INDEX FUNDS WITH HEDGE EXEMPTIONS
Require that an index fund with a hedge exemption restrict its position in a commodity to the dollar allocation or the percentage of funds allocated to that commodity as defined in the fund's prospectus and recorded with the CFTC. Further, any variation should be subject to speculative position limits, and that such funds should report their cash positions on a weekly basis.

REQUIRE FULL REPORTING & CFTC MONITORING OF ALL MARKET PARTICIPANTS
Recommend that the CFTC monitor and oversee all swaps and OTC activity by requiring the reporting of all swap and OTC contracts by market participants, and that the CFTC determine the aggregation of positions from all sources, including the exchanges, ETFs, swaps, OTC, and all other trading entities.

SEPARATE REPORTING CATEGORIES FOR NON-TRADITIONAL HEDGERS

Require that all non-traditional hedge accounts, those not involved in the commercial enterprise of physically trading bales of cotton, be reported as a separate individual category.

MARGIN FUTURES TO FUTURES & OPTIONS TO OPTIONS SETTLEMENTS
Require that the ICE and its clearing members adhere to the practice of margining futures to futures settlements and options to option settlements and that only those involved in the physical handling of cotton be eligible for hedge margin levels.

HEDGE MARGIN LEVELS
That only those involved in the commercial enterprise of physically trading bales of cotton, shall be eligible for hedge margin levels.

STUDY IMPACT BEFORE INCREASING SPECULATIVE POSITION LIMITS
Urge the CFTC to study the impact on price discovery and volatility, prior to any additional increases above current levels in speculative position limits in the single months or all months.

The CHAIRMAN. I thank the gentleman. I thank each of you. I will now recognize Members, each for 5 minutes of questioning. I yield the first 5 minutes to myself. Mr. Niemeyer, in your testimony you say you don't want the commodity bubble to burst, and that you believe the bubble is not caused by ethanol but by nontraditional investors, as you say, playing in the commodity markets. However, wouldn't many of the proposals that you recommend force those investors out of the market, and wouldn't that have the effect of bursting the bubble if we force them out of the market?

Mr. NIEMEYER. First of all, Mr. Chairman, we are not interested in eliminating anybody from trading. We just think they ought to trade by the rules. I grow corn, the elevator stores corn and——

The CHAIRMAN. I understand that, but how can you move—if you assume the speculators are in, and I will assume that is the assumption, how do you move them out?

Mr. NIEMEYER. I am not trying to move them out.

The CHAIRMAN. A corresponding drop in prices, I guess.

Mr. NIEMEYER. I am not trying to move them out. What I am suggesting is as a hedger, if I go to hedge grain, it costs me $1,500 to contract currently to maintain a position. I grow all those—handle the grain, but as speculators come in, their margin money should be 20, 25 for the same position, so in a sense they have a 24 percent advantage because they don't grow the corn, they don't store the corn, and they don't transport it. All we want is fairness in the market. If they are a speculator, they should be considered a speculator. If they are a hedger and they handle the grain, they handle the physical commodity, then they should be a hedger and get that advantage.

The CHAIRMAN. Okay. Thank you. Mr. Weil, if the markets are not true indicators of cotton prices, do you know what cotton farmers are using to base their decisions on whether to or how much cotton to plant this year? Do you think the problems being experienced in the cotton market will have—what will that have or how will that impact their planning decision this year?

Mr. WEIL. Mr. Chairman, growers, first of all, I think they look to the farm bill for some support going into the next crop. In terms of finding a contract from a merchant such as myself or a cooperative, it is very difficult for them. So, yes, they may think about how much cotton they will plant, and in certain areas of the country they can plant other crops such as corn and soybeans down our way. But, yes, this could have an impact on their decision.

The CHAIRMAN. Okay. Thank you. Mr. Farley, you heard the comments a few minutes ago from Mr. Weil as it related to the March situation, and I know you were taking notes. So my question to you is how do you explain in March a pricing range from about 84¢ to $1.00, and it seems incredibly large when those holding cotton it was pretty clear, 63¢, 64¢. Furthermore, I understand that a senior USDA official has raised that issue with the CFTC in a forum about that very event stating basically that all fundamentals in the marketplace at the time appeared to have been bearish, suggesting there is no reason cotton prices should have made such large movement upwards at that point. So since the traditional basis for forward purchasing of U.S. cotton from growers is typically 350 points off the—plus or minus off the highest futures price,

they were off 250 points at one point during that day. What happened? And I guess what could have caused such an enormous deviation or divergence between cash price and future option prices for essentially an identical bale of cotton?

Mr. FARLEY. Thank you, Mr. Chairman. I would be pleased to answer that question. If I can go back a few months, the price move in cotton, even going back to February 2008, the price of cotton was 54¢ and then moving forward in time to—excuse me, February 2007, 54¢, and then the last trading day of February 2008, the price was 82¢. And so that is kind of setting the stage for what occurred on the trading days of March 3 and March 4. Looking at that move, which is a very significant 28¢ move leading up to that time. There are a lot of supply and demand factors which have been discussed at this hearing several times by other panelists I won't go into in detail, and mentioned in my testimony, suffice it to say that despite the near term bearish fundamentals that you described, there are many long-term, bullish fundamentals.

So now on March 3 and March 4 what you saw trading in the market was not traditional supply and demand. It was liquidity, and there was a perfect storm, if you will, in the cotton market. There was really three waves crashing together tossing the cotton market around. One was that rising price from 54¢ to 82¢. The second was on March 3, March 4 the cash market, as I understand it, all but shut down. So, while as you described the price was 250, the basis was 250 points off, it actually was—it was difficult to get even that price. It shut down. And the third wave was that we are in the middle of a global liquidity squeeze, so when the price got to 82¢, it became very difficult for these producers, farmers, producers, the co-ops, to finance their short margin positions with the exchange. And on March 3 the price jumped 12¢.

And as Mr. Weil described in detail, their lenders on that evening required that they close out their hedge positions on March 4, which yielded another volatile day. We as an exchange, we don't operate a spot market. We operate a futures market, and our job is to provide a venue for price discovery, and we look at trading activity to determine if there is a price being discovered. On March 3 and 4 there clearly was. On March 4, we did 155,000 options. To put that in perspective, that is the most options we have ever traded on our exchange. There clearly was price discovery going on. Thank you.

The CHAIRMAN. Thank you. I would like to follow it up but my time is expired. I will yield to the gentleman from Kansas.

Mr. MORAN. Mr. Chairman, thank you very much. Mr. Clark, thank you for your continued conversation about convergence. I appreciate that. Is there something, I still want to go back to what I asked an earlier panel, historically is something different today than there has been in the past; that we see a greater inability over time for the cash and futures price to come together at time of delivery?

Mr. CLARK. I answer that question by saying, "Yes, there clearly is something fundamentally different about these markets today than there have been in the past." I mention it in my testimony, and it has been mentioned already today. Transportation costs are two to three times higher than what they used to be. Storage costs

are higher than what they used to be. The cost of carrying the commodity from 1 month to the other is higher because interest rates—because the price of the commodity itself is higher. It costs more to finance those inventories. There are a lot of fundamental reasons why convergence is not happening the same way that it always has.

But I would suggest that there are—that is what makes this so difficult is because there are real reasons but it is not that—if it wasn't happening the same way that it always has, that is fine as long as it is happening consistently. In other words, if they used to converge within five percent of each other and the price is twice as high or three times as high, you factor all those things in, then it should be converging within 15 percent of each other.

Mr. MORAN. None of those things seem to be nefarious. They are circumstances we face with changing prices, particularly as it relates to energy and transportation costs. What it suggests to me is that economically those two points have to come together or we are dealing with a system in which there is inadequate information to make the predicted estimate as to what the futures price should be, is that right?

Mr. CLARK. I think that is correct.

Mr. MORAN. And so as the world has changed, the markets have changed, we are not capable at this point of having sufficient knowledge to make the price of our futures contract the appropriate price. Maybe I am focusing too much on the futures price. Maybe we don't know enough about the—the cash market is set. There is a buyer and seller on that particular day, and so what we are lacking is knowledge about what the price is going to be in the future which is what the market is designed to——

Mr. CLARK. That is correct, and that is why the contract has lost its utility as a hedging tool. Because it is not happening, and it is inconsistent, and there is something fundamentally wrong about the futures contract if that convergence is not happening. I think we can point to a lot of the reasons. We can look at a lot of the reasons, but that fact of the matter it is not happening, and producers are losing their ability to use it as a hedge and we certainly are too.

Mr. MORAN. Well, do futures markets increase or decrease price volatility? Do we have more price volatility because there is speculation in futures markets or do they reduce price volatility?

Mr. CLARK. Well, I think there is something important here that as I have sat here all day and in some of the exchanges have made the comment, Mr. Scott asked the question, "Isn't it fundamentally correct that their investment funds provide stability to the market?" I think it is important to understand that just because they bring volume to the market doesn't mean they are bringing liquidity to the market. Just because they are bringing volume to the market doesn't mean they are bringing liquidity because they are passive, they are long only. They never change. They come in. They stay long, and they stay long forever. Therefore, they are not trading the fundamentals of the market like the cash market does, and therefore they are having an influence on convergence.

Mr. MORAN. I think it goes back to Mr. Etheridge's earlier point about setting a base or a floor, as he said, in price. And you men-

tioned, Mr. Clark, about perhaps restricting the market participants or perhaps the products that they invest in. Is that a fair statement of what——

Mr. CLARK. We have said that right now this market is in an unprecedented time. We are all struggling to figure out why these markets are acting the way they are. We believe very firmly that right now is not the time for the CFTC to continue to grant hedge exemptions to these kinds of passively traded funds. We think they need to put a moratorium on it. We are not against these monies coming in to our marketplaces. We just think we are in an unprecedented time. There has been so much change that the market needs time to adjust to that.

Mr. MORAN. Your testimony I think focuses on the problems that my grain elevators and co-ops have in this current market, and you focus upon the participants in the market. I assume that there is another side to this problem, which I don't know, which one is the one that deserves the most attention, but there has also got to be a credit problem. Your inability, I don't mean this in a pejorative way, but you blame the futures markets and the circumstances that your grain elevators face, but on the other hand the problem you face derives from the fact that you have the inability to access credit.

Mr. CLARK. There are two issues which we struggle with the most, one of which is convergence, which we have already addressed, which means the utility of us to be able to hedge our position is more difficult than it has been in the past. That needs to be fixed. That is one issue. The other issue is an issue that has more to do with high prices and volatility than anything. It is because prices are going up. Traditionally we are short, as most of our members, although we have members who are long hedgers, but if I am a country elevator and I buy grain from a farmer, I am going to sell it or hedge myself on the Chicago Board of Trade.

When the price of corn goes up $2.50, I have to keep margining those positions. Somebody from the CFTC said earlier this morning that, "It is no big deal for the big companies because they have the capital to withstand it," I beg to differ. If you have a nationwide operation where you are buying grain all over the nation and the price of corn goes up $2.50, and you are margining that position all the way up, you have a catastrophic problem. It is a catastrophic problem that we cannot continue to finance these positions. If we have a situation this summer where we have a drought, and the market, we have a runaway market like we had in wheat in Minneapolis, I think everybody needs to understand this problem is going to be huge. I think you will see we have problems already that grain companies are not buying deferred positions. That is going to be more prevalent and it is going to be a real problem.

Mr. SCOTT [presiding.] Mr. Neugebauer.

Mr. NEUGEBAUER. I thank the chair for allowing me to go out of order here. I want to go back to Mr. Farley just a little bit, and I agree that markets are very efficient as long as there is not any circumstances that would cause markets to be inefficient. And I know that on your exchange you can trade commodities both with options and with futures, is that correct?

Mr. FARLEY. That is right.

Mr. NEUGEBAUER. And I think the limits, for example, on cotton is 300 points, the daily limit, is that correct?

Mr. FARLEY. There is an exception to that rule but in general.

Mr. NEUGEBAUER. Generally it is 300?

Mr. FARLEY. 300.

Mr. NEUGEBAUER. And so these special days that we have been talking about, I understand it that while the futures were limit up the margin calls were not based on the limit move but on the closing price of the options that day. People that weren't even participating in the options were forced to make—normally you would make a margin call based on the limit move, is that correct?

Mr. FARLEY. We have had a policy for about a decade of margining the way you described.

Mr. NEUGEBAUER. And so all of a sudden the rules changed, and the people that thought that day that they were going to have to make a margin for a limit move had to make a margin for what would be the equivalent of four or five limit moves, is that correct?

Mr. FARLEY. I am sorry, Congressman. I wasn't specific with my answer. We didn't change anything. We have had the same policy for a decade, and we didn't change anything on March 3 and March 4.

Mr. NEUGEBAUER. So people did not have to put up a higher margin than just a limit move?

Mr. FARLEY. They did. If I can, just by way of background. What you are describing is the price limit structure that is now really specific to the domestic agricultural markets. Going back 20 years, you can understand why these limits are in place. Money flows took a day or 2 and price dissemination to rural areas and other countries takes a while. For these small periods you put the price limits in place, and now our exchange as well as the other domestic exchanges represented here have these price limits in place, and we are no different. Most markets have moved away from these and we still have them. In the first 60 days of this year, we hit these limits 18 times. The most pronounced occasions were March 3 and March 4, and what I mean by that was the options price was the furthest from the futures limit up price.

Going back to close to a decade ago, our Board which was then composed of industry leaders, this is prior to the ICE acquisition of NYBOT, our Board put through a policy to margin the way you have described. That is, use the synthetic price or the real price being discovered in the options pit as the margining price for both futures and options. And it is a prudent rule. It really protects the clearinghouse which is of paramount importance to us. And that rule was approved by our cotton committees and our product committees at that time. And so on March 3 and March 4, we didn't do anything different. The unfortunate reality for the industry is that the move was so significant that it put tremendous pressure on our customers to be able to come up with that money. As Mr. Weil indicated earlier, the margin requirement that day was over a billion dollars. I hope that answers your question.

Mr. NEUGEBAUER. So when I asked you the question before, you said affirmative but then you are saying that you misspoke and

that this policy of using the options for discovery or the limit was whichever higher has been the policy for 10 years?

Mr. FARLEY. I believe that figure is 8 or 9 years. I don't have the exact date, but that is right.

Mr. NEUGEBAUER. And does that give any credit to the fact that some of the people trading in that way actually own the commodity, holding the commodity, and other people that are not holding the commodity?

Mr. FARLEY. There are two different types of margin at a clearinghouse. There is initial margin and variation margin. In the case of our initial margin, we do differentiate between the two different types of traders. Whereas, variation margin is more straightforward at the end of the day we determine what is the best available price for margining purposes; and that determines the market to market value of all the hedges, both futures and options.

Mr. NEUGEBAUER. I think all of us want the marketplace to function as consistently as it can. I think the problem is, and it has been articulated here by the people that are either storing or merchandising or growing these commodities because of these anomalies, as you call it, that happened. Basically, what it has done is it has taken a lot of people out of the marketplace that have been able to help producers manage their risk, and so that means that it is not working. Now I am not going to be one to radically throw out the baby with the bath water here, but I do think, and I would hope, that instead of relying on us, I would hope that the industry would sit down and start talking about making sure that we have a structural marketplace in place.

I know that we have moved to electronic trading one of those days or very closely to that date. I just want to make sure that we are accomplishing the original goal here, and that is that these markets are really designed to help the agricultural market. Now I understand a lot of people want to hold American commodities because our dollar is diving and that one of the hedges for the dollar would obviously be to move into the commodities, and I understand that. That is something we have to address as well. I know my time has expired, and I would ask that Members be allowed to since this is such an important subject without objection that Members be allowed to submit questions to our panelists and hold the record open until such time as we get responses to those questions.

Mr. SCOTT. Absolutely. We thank the gentleman from Texas for his insightful questions. I have a couple of questions I would like to ask. First, Mr. Farley, it seems that volatility is affecting a broad array of commodities. Looking at the different agricultural products that have traded on your exchange, how does your exchange work with the affected industries in periods of high volatility?

Mr. FARLEY. Sure. I would like to answer that in two parts if I can. With respect to what the exchange can do in the period of volatility, the markets are volatile when the supply and demand equation is out of bounds or if supply or demand is growing—one is growing faster than the other. And today demand growth is far outstripping supply, and in that situation what an exchange can do primarily is continue to provide a mechanism for discovering price. It is by discovering that price and in these cases a high price that

is going to attract additional investment capital, additional infrastructure into these industries and ultimately bring down the price of these commodities and the volatility of these commodities.

Specifically, in terms of what we do to work with the industry, I think our exchange is unique in the respect that we work very closely with our industries. Each of our major products has a contract committee that is composed of industry leaders. In cotton, for instance, we have a panel made up of 20 industry leaders. The three CEOs of the top three cotton merchants globally are on that panel. And we actually cede the codification of the terms and conditions of our cotton contract to them. This is a really turbulent time. In a turbulent time, we need to work with that group, that committee, even more than usual. And I agree with what Congressman Neugebauer said, which is we should really work together on these issues and find common ground.

Mr. SCOTT. Right. Let me ask you this. I just have a couple more follow-up questions, and then I have a general question for everyone. But, Mr. Farley, recognizing that price discovery and risk management are the primary functions of the futures market, I don't quite understand why your exchange would set price limits on its futures contracts. You mentioned that you allow options to continue trading when futures hit the limit to provide a way to continue the price discovery function, but could you maybe a little better explain how that works?

Mr. FARLEY. Well, these limits are a bit anachronistic, and they exist largely in the domestic agricultural commodities. The argument for price limits is that they prevent panic, a panic scenario, and by leaving the options open you provide a vent or a steam pipe during these periods where there is a lot of built up tension. Most markets have moved away from these limits, and it is something that we are evaluating together, and when I say together I mean with the industry what is the right structure. Are these anachronistic but they work or do these need to be substantially revised or even eliminated.

Mr. SCOTT. The other part of that question, I wanted to get to the issue of the unregulated OTC trading of commodities that lacks transparency and yet has a major impact on the market. These opaque markets, what is your exchange doing to rein them in?

Mr. FARLEY. I am the President and CEO of ICE Futures U.S. which we are a CFTC designated contract market here in the states, and we primarily trade in agriculture. Much of the talk on the earlier panels about ICE centered on our energy business. Since I can't speak directly to that, but I would like to give a couple thoughts. The first thing I would like to say is that ICE as a broader company including the parent organization strongly supports any efforts at increasing transparency in these markets. I would like to correct the record of earlier testimony. ICE took a proactive stance on working with this Committee and Congress on the bill that was passed yesterday, and that bill does include position limits for the highly liquid OTC contracts which is a meaningful distinction from one of the discussions earlier.

And ICE in general takes great pride in bringing transparency to OTC markets. In the energy markets a decade ago there was black and white. There was the listed market, which was perfectly

transparent. There was the OTC market, which was perfectly opaque. And into that were all the ICE shades of gray if I can carry the metaphor maybe a little bit too far.

Mr. SCOTT. I think you did, and I certainly appreciate that answer. My time is slipping away. I did want to get this question in because I don't think we could leave this day without putting this question on the table particularly for you all who have to deal in the commodities markets. The big issue now is the high cost of fuel and food. The agriculture industry and the Agriculture Committee has expanded its territory in a very significant way of being the arbiter of those two essential areas. Especially as we now move to renewable energies, which is basically agricultural products. And chiefly now we are at a problem of corn with the downward pressure on corn and our over abundance of using that for ethanol.

We have just passed a farm bill. I would like to get your opinions on do you think that we have done enough in terms of what we have done in the farm bill of taking some of that pressure off of corn by decreasing the tax credits on corn-based ethanol and increasing the tax credits for cellulosic ethanol. And given the time frame of getting these new cellulose ethanol plants up and running, do you think we are too far behind the curve? What can we do to do a quicker—what is your assessment? Have we done sufficiently in this farm bill? Is there more we need to do to take the pressure off of corn, and what do you see the future in that area? Very quickly.

Mr. NIEMEYER. Congressman, first of all, I want to thank you for everything that you have done in the farm bill in passing it. I don't disagree with anything you said. Technology is moving at a fast pace. We are working right now with corn cobs, corn stalks, to make cellulosic ethanol. We have the technology. Maybe we don't have it down pat yet but we are going to get it at a very reasonable price. The one thing that Congress shouldn't do, it must not repeal the current RFS. We will have numerous economic studies that have indicated that the current ethanol demand has had very little role in the increase of corn prices, but a repeal of the waiver would have a significant psychological impact on the commodity markets that would virtually create a commodity bubble.

The CHAIRMAN [presiding.] I thank the gentleman. His time has expired. The gentleman from Georgia, Mr. Marshall, for 5 minutes.

Mr. MARSHALL. Thank you. I had to step out and meet with some folks from the German Parliament to talk about NATO security issues so a little transition here. And actually my question probably was being addressed given what I just heard. During the first panel you all probably heard Mr. Fenton estimate or at least say that they had estimated that the impact of the weak dollar on the increase in the cost of oil was about 25 percent. That was his rough guess, and he described how they came about that estimate. What we hear is that there are various market forces that are causing the increase in food prices. One of the things that we regularly hear is that the decision to move to ethanol is one of the market forces that is causing this increase in food prices; and it is because so much of our acreage is now devoted to energy that might otherwise be devoted to producing food.

And I think I just heard you, Mr. Niemeyer, is it, I think I just heard you say you have studies that tend to show that is not the case. I would be very interested to hear to what extent.

Mr. NIEMEYER. We have a lot of studies. One of the things that we have talked about today, this being a hearing on the CFTC, was are these markets really reflecting fundamentals. You know, in 2005–2006 marketing year our price of corn was $2 a bushel, and at that same time that is the year you passed the first renewable fuel standard bill. Quite honestly, I thought it was very interesting because at that time we were producing, we were utilizing about 1.6 billion bushels of corn to make ethanol, and now we are going to be using 3. So that was an increase of 1.4 billion bushels of corn going to ethanol. But in the same time frame that nobody seems to want to talk about, we went from 11.1 billion bushels of corn to 13.1 billion bushels of corn, which is a 2 billion bushel increase. So even though we had a 2 billion bushel increase in supply, we only had a 1.4 billion bushel increase in demand on the same time frame, I just don't think that justifies a $3 plus move in the corn price.

The other thing is as a farmer and as a trader, I look at the Chicago Board of Trade, and I see that this last year we produced a 13.1 billion bushel corn crop. Currently, we have a 1.3 billion bushel carryover. I don't get it. There are elevators at home full of corn. There is corn laying on the ground. And then we have this problem of convergence. There is a larger demand for futures than there is for cash. The same thing happened in the wheat market by $2.50 a bushel. That is the reason the bankers will not lend elevators the money to margin more grain, and then I am put in a position of margining my own position which really creates a lot more of a problem.

Mr. MARSHALL. Right. Any of the others? Mr. Clark.

Mr. CLARK. I am not sure that I am expert enough to comment on what percentage of the price move has been responsible for ethanol, so I won't even want to try to comment on that. I think there are a lot of studies out there being done by universities and other people that are trying to peg that. But I think unquestionably, without a doubt, there is unprecedented demand for commodities. There is nobody in this room certainly that could deny that. There is unprecedented demand for corn. We simply cannot raise enough corn. And you can say that, soybeans, wheat, whatever the case may be, we are struggling in the United States to grow enough commodities to meet the overall demand.

And you ask it in the context of the farm bill. Our position at the NGFA, we are disappointed that the farm bill did not open up some CRP ground to let out some fully sustainable tillable ground and allow us to produce more.

Mr. MARSHALL. Well, that just wasn't going to happen. I tried.

Mr. CLARK. I know that.

Mr. MARSHALL. I sort of tried to lead the way a little bit.

Mr. CLARK. We have to find a way to grow more commodities.

Mr. MARSHALL. And is that because there is a world market?

Mr. CLARK. As the dollar weakens and as other countries get more wealthy, they move from when you were eating meats, China

into the market eating two to three meals a day now, and India, it is worldwide demand and it is real.

Mr. MARSHALL. The problem that most folks have with this is to the average consumer this has happened in the last 4 or 5 or 6 months, and these trends we have been discussing are trends that have been going on for really quite some time so what is unique now is what people ask us. That is a statement. My time is up. I appreciate—I would be very appreciative of any follow-up that you might care to give to the Committee that identifies what is different now, and if nothing else maybe you are going to be suggesting again that it has something to do with these OTC funds and something with the markets. I don't know.

Mr. WEIL. I would like to make a comment. Right now there are no spec limits especially on the OTC funds, and their influence on the market is building, and I think that has added some volatility to certainly the cotton futures. I can't really speak to the other commodities. I am sure that is the case as well. But that is a place that in our recommendations we would like to see more transparency with regards to the OTC, and they should be limited. Certainly, those that are not traditional hedgers should be in a different category and recognized as such and limited to a degree. Right now the lenders who finance the industry are extremely fearful. They don't understand what is going on, and that is our life blood as our excess capital whether it be banks or holding companies somewhere.

Getting on to another subject with the supply of cotton and why the fundamentals were completely—the fundamentals were just completely ignored. Cotton is at a 50 percent stock to use ratio. If we don't plant one seed of cotton this year, we have enough cotton to supply the world. We, being the world, have enough cotton to supply the world's needs for 6 months, and we are going to be planting cotton this year. Producers have a capital commitment to cotton all over the world. They do in this country. They have been paring that down because they see a lot more track of this in the grain markets, but they still want to grow cotton. I mean that is their expertise, and they still want to pursue that. And thanks for passing the farm bill. That certainly gives them some relief.

The CHAIRMAN. Thank you. Let me thank each of you for your patience today through the voting. Fortunately, we only had one set. This I think has been an excellent hearing. I thank you for your participation, and I would say to you that we will have more in the weeks to come because I think this is an issue that requires our attention. This is an important issue for the American consumer, and with that, I would ask the Ranking Member if he has any final comments before we adjourn.

Mr. MORAN. Mr. Chairman, thank you. I agree with you this has been an interesting and useful hearing, and I appreciate the testimony we have heard from all three panels. I have a couple of additional questions, particularly from staff that I would like to submit to our witnesses in writing and ask for their response. And I look forward to working with you in the next few weeks as we determine what direction we go in additional hearings.

The CHAIRMAN. I thank the gentleman. And let me just ask each of you, other Members will submit questions, and if you would

within the next 10 days, please get that back to the Committee. I would appreciate it. Under the rules of the Committee, the record of today's hearing will remain open for 10 days to receive additional materials and supplement a written response from witnesses to any questions posed by a Member of this panel. This hearing of the Subcommittee on General Farm Commodities and Risk Management is adjourned.

[Whereupon, at 2:15 p.m., the Subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

Written Submission
of the National Cotton Council
to the
General Farm Commodities & Risk Management Subcommittee
House Committee on Agriculture
Regarding Public Hearing Reviewing Commodity Markets

The National Cotton Council (NCC) is the central organization of the United States cotton industry. Our members include producers, ginners, cottonseed handlers, merchants, cooperatives, warehousemen and textile manufacturers. Approximately 25,000 thousand cotton farmers produce a crop with an annual farm-gate value in excess of $5 billion.

While a majority of the industry is concentrated in 17 cotton-producing states, stretching from the Carolinas to California, the downstream manufacturers of cotton apparel and home furnishings are located in virtually every state. The industry and its suppliers, together with the cotton product manufacturers, account for more than 230,000 jobs in the U.S. The annual economic activity generated by cotton and its products in the U.S. is estimated to be in excess of $100 billion.

The NCC would like to thank Chairman Etheridge for holding this very important hearing to review recent movements in commodity futures markets. In recent weeks, all segments of the cotton industry have felt the impacts of the disruptive and uncertain nature of the New York futures markets. Many of the concerns felt by this industry were conveyed in testimony by Mr. Andy Weil, current President of ACSA, at the May 15 hearing.

The NCC would like to take this opportunity to reiterate a number of points and recommendations made by Mr. Weil and also stress the importance to of a well-functioning futures market.

Unfortunately, the cotton futures market is dysfunctional at the current time. The impact of unregulated investments by index funds and other speculators have resulted in a significant divergence of cash and futures prices. This scenario is common to grain, oilseed and cotton markets but appears more severe in cotton futures trading. As an example, synthetic cotton price increases that had no relevance to the fundamental market conditions rose over thirty percent in one day in early March and continue to be highly volatile.

The New York Cotton Exchange was founded in 1870 as the first commodity exchange in this country and has served this industry well for over 100 years. The frustration shared by members of the cotton industry stems from a cotton futures market that is now unable to discover future prices with any historical correspondence to cash prices and provide a hedging mechanism. Cotton merchants are no longer offering forward contracts to producers because of extreme price risks. A large Memphis merchant was quoted as saying their company has not bought a single bale of cotton in a month because they didn't know how to hedge it.

Likewise, producers are unable to convince their bankers to assume similar risks for their own price protection. Therefore, as cotton prices have soared and plunged over the past month, producers, along with merchants are merely bystanders.

Not only have we been on the outside of the market, we are also deeply troubled about the impact this recent price volatility has had on the liquidity of buyers. Traditional merchandising relationships between growers and buyers have ceased because price risks are too great for short hedging purposes. Growers continue to be concerned about the financial viability of buyers with whom they have previously contracted new crop sales. This situation equally applies to growers who trade with private merchants and those who belong to marketing cooperatives. The inability of merchandisers to hedge their risks translates into a weaker basis and lower prices offered to the cotton producer. Each penny reduction in the price of cotton means that US cotton famers loose $85 million in revenue.

Cotton futures markets must be returned to their historical function of price discovery and risk management relative to real market conditions. Cotton producers face extreme pressures from escalating input costs which threaten their viability and yet currently have no mechanism to forward price their production at reasonable costs.

We urge Congress to provide CFTC with the necessary authority and resources in order to better protect market participants against manipulation. All industry segments concur with recommendations from our merchandizing segments that call for more transparency in trading and reporting. In addition, CTC should regulate swaps and Over-the-Counter (OTC) activity by requiring reporting by market participants of such activity.

Speculative limits and reporting requirements must be consistent across all market participants. Consideration should also be given to increasing speculative position margins and disallowing any increase in speculative position limits. We understand the importance of speculative participation in a viable futures market. However it is incumbent upon the CFTC to use its authority to regulate futures markets so as to provide meaningful risk management and price discovery.

Many in the cotton industry question what the public policy position of the CFTC should be regarding futures markets. Should these markets be regulated so that their primary purpose is to facilitate the cash market by providing price discovery and risk transfer, which has been its historic role? Or should they be regulated so that their primary purpose is to provide an investment vehicle to invest in commodities without taking title to the physical commodity? Our concern is that it has become the latter and that is not healthy for cotton or any commodity markets. Restoring confidence in the futures market is of the utmost importance to this industry.

Thank you for the opportunity to share our concerns.

Submission of Woods Eastland, Representing AMCOT
House Agriculture Committee
Subcommittee on General Farm Commodities and Risk Management
May 15, 2008

I am serving as President and CEO of Staplcotn, a cotton marketing cooperative. Staplcotn is a member of Amcot, the trade association of Calcot of Bakersfield, California, Plains Cotton Cooperative Association of Lubbock, Texas, Staple Cotton Cooperative Association (Staplcotn) of Greenwood, Mississippi, and Carolina's Cotton Growers Association of Raleigh, North Carolina. I am submitting this statement on behalf of Amcot.

The public policy of the United States in regard to the practices of regulated commodity exchanges is embodied in the Commodity Exchange Act 7 USC/et seq. Title 7, Chapter 1, Section 5 states:

> (a) Findings
>
> The transactions subject to this Act are entered into regularly in interstate and international commerce and are affected with a national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities.
>
> (b) Purpose
>
> It is the purpose of this Act to serve the public interests described in subsection (a) of this section through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission. To foster these public interests, it is further the purpose of this chapter to deter and prevent price manipulation or any other disruptions to market integrity; .....
>
> Section 6(a) "Excessive Speculation" further states:
>
> Excessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets or 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 burdens, the Commission shall, from time to time, after due notice and opportunity for hearing, by rule, regulation, or order, proclaim and fix such limits on the amounts of trading which may be done or positions which may be held by any person under contracts of sale of such commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility as the Commission finds are necessary to diminish, eliminate, or prevent such burden.

The strongest evidence of whether a contract market satisfied its obligation to the public interest of managing and assuming price risks, discovering prices, or disseminating pricing information, and preventing excessive speculation or unwarranted changes in the price of such commodity so as to constitute an undue and unnecessary burden on interstate commerce, is the

relationship between the futures price and the cash market price of the commodity. Not only is convergence during delivery expected, but also a normal range of the spread or basis between the two markets during trading between delivery periods. A normal basis spread over time is readily observable and should be expected in a contract market meeting its obligations to the public. When divergence between cash and futures of an abnormal degree occurs, that contract market is failing to meet its responsibility to the public under the Act, and its Board and management, and the Commission, are statutorily bound to take immediate corrective action.

The Cotton Situation

The fundamental cotton supply and demand background against which the cotton cash market and ICE Futures US have been trading is one of the realization of increasingly burdensome supplies.

Monthly U.S. Cotton Supply/Demand Estimates
For
2007 Crop Marketing Year
(August 1, 2007 – July 31, 2008)
Source: USDA
(million of 480 lb. bales)

	2007 Production	Projected 2007 U.S. Mill Use	Projected 2007 U.S. Exports	Projected 7/31/2008 Carryover
August	17.4	4.6	16.7	5.8
October	18.2	4.6	16.7	6.4
December	19.0	4.6	16.2	7.7
February	19.0	4.6	15.7	8.2
March	19.0	4.6	14.5	9.4
April	19.4	4.7	14.5	9.7

Against this background, please observe the behavior of cotton futures from July 2007 through April 16, 2008. This is a daily continuation chart of futures only, limited by their daily trading limit. If it were adjusted to reflect the synthetic high value of the May Futures contract as measured by the value of call options on that futures contract, the high would have been $1.09.

(See Attachment – **Cotton Daily Continuation Chart)**

Now please observe the behavior of the cash market during this same period of time, as expressed as a basis (cash minus futures). The cash market presented is the average daily cash price on the Seam, a liquid electronic cash market that has two sales venues, grower to buyer sales and buyer to buyer (inter-merchant or inter-shipper sales). The daily sales volume for each appears below the basis graph.

(See Attachment - **Grower to Buyer Sales Graph)**

(See Attachment - **Buyer to Buyer Sales Graph)**

The failure of the cash market to follow futures and thus their divergence, is readily apparent by measuring the deterioration of the basis. After trading in the grower to buyer venue

at an average of about 550 off from 7/01/07 through 2/11/08, it deteriorated to 912 off on 2/21/08 (on volume of 40,618 bales) and continued to deteriorate to 2546 off on 3/4/08 and 2873 off on 3/05/08, and has remained wide thereafter. Results in the buyer to buyer venue are similar.

Where Are We Today in Cotton?

(1) The futures and options markets today are not reliable discoverers of prices. When futures increase 21.15¢ in absolute terms (February 20 – March 4) and 30.87¢ in synthetic value while the cash market (as measured by the Seam's Grower to Buyer market) increases 4.21¢/lb, any semblance of a reliable relationship upon which business decisions can be made is destroyed.
(2) The futures and options markets are not reliable vehicles for transferring risk. A buyer who bought physical cotton on the Seam from a grower on February 20 at 63.38¢/lb, hedged the purchase at spot month futures of 72.19¢, and then sold the cotton on 3/04 at 63.40¢ and bought back his short hedge would have lost 16.65¢/lb, or 26.3% of the purchase price. This certainly fits the Act's definition of an unreasonable fluctuation or unwarranted change in the price of the commodity that constitutes an unnecessary burden on interstate commerce.
(3) Fear of a repetition of these events prevents the middlemen between producers and mill consumers from entering into forward crop contracts, unduly burdening interstate commerce in the commodity.

During and since these occurrences, the management and Board of Ice Futures US has failed to fulfill its self-regulation requirement under the Act to meet its statutory obligation to the public, and the Commodity Futures Trading Commission has failed to fulfill its statutory obligation under the Act to force the management and Board of Ice Futures US, and other contract markets similarly impacted, to take such action. I understand that the situation is not unique to cotton.

Why Do These Markets No Longer Serve As Acceptable Vehicles for Price Discovery and Risk transfer, and What Can Be Done to Restore Them?

In governing an agricultural futures market, every decision must recognize one salient fact – the number of true hedges of the physical agricultural commodity that can be placed in the contract market is finite because it is dependent on the size of the crop, and how much of that limited supply remains unconsumed. All futures or options positions in excess of that number are not true hedges of the physicals. This is recognized in the Act and has historically been recognized by placing limits on the size of the positions of every class of market participant. What was historically achieved was a careful balance between hedgers of the physical commodity and speculators, that kept the relationship between the price of the futures contract and the cash commodity within a historically recognized range that was generally accepted by the trade in their cash contracts, thus not burdening interstate commerce. Achieving this balance was made easier in that many classes of pooled money, such as pension funds, chose not to trade in commodity markets under the belief that they were too speculative. The agricultural commodity markets thus were governed and regulated overwhelmingly in order to facilitate the flow of the physical agricultural commodity through the distribution chain. The fact that most of the approved contract markets were not organized for profit meant that the owners and the Board they elected were concerned most with achieving price discovery and risk transfer for themselves.

All this changed and has thrown things out of balance. Currently there is an inherent conflict of interest between the management and Boards of for profit exchanges and their self-

regulatory obligation. To limit market participants to achieve the requirements of the Act potentially costs them trading volume, which costs them money. Also the open interest position of speculators and of traders defined by the CFTC as "hedgers", but who don't trade the physical commodity in interstate commerce has grown exponentially. Consider for instance that the dollar volume of investor funds tied to the Standard & Poor's Goldman Sachs Commodity Index (S&P GSCI) has grown from $60 billion in 2006, to $85 billion in 2007, and is projected by some to reach $100 billion in 2008. (Source: Pastine, Alejandro S., "Speculation and Cotton Prices," Cotton: Review of the World Situation, International Cotton Advisory Committee, Volume 61 – Number 4, March-April, 2008). This excellent analysis points out that even though the dollar value of index traders funds has increased dramatically, in cotton at least, "index traders have not been the main force behind the increase in open interest for cotton futures and options, but non-index traders speculators have." It includes the following table:

	Speculator's Long Positions, by Trader (averages)								
	Speculator's Long Positions					Trader's Long Positions			
	Total	Index	Non-Index Traders			IT/Total	Non-IT	Non-IT Long/ Non-IT	Non-IT Spread/ Non-IT
Year		Traders	Total	Long	Spread	Spec	Total Spec	Total	Total
2006	144,679	72,813	71,866	26,098	45,768	50%	50%	36%	64%
2007	243,682	96,149	147,533	53,458	94,075	39%	61%	36%	64%
2008	317,420	111,382	205,638	83,471	122,167	35%	65%	41%	59%

The huge increases in open interest in agricultural futures markets, driven by the acceptance of commodity futures as an investment grade asset class and the emergence of the long only index funds, both coupled with the phenomenon of contract markets operated and managed for profit, have thrown these markets into disorder. The finite nature of the volume of contracts of the agricultural commodity that can be entered into by the true hedger remains the same – it is limited to the volume of the crop produced that remains unconsumed. However, the volume of contracts now being entered into by non-hedgers of the physical agricultural commodity is growing almost exponentially. Since the index fund component of these must always be long, there must exist a logical bias for the non-index speculators to be unduly long also. The self-regulation concept of the CFTC has failed. It seems to be asking too much of a for profit contract market on its own initiative to take action that limits the increased participation of the index trader and non-index speculator trader sufficiently to return enough balance so that the markets are returned to their mandated function of providing price discovery and risk transfer. Additionally, during the times these changes in market participants have occurred, the CFTC has accommodated the desire of the for profit exchanges to increase open interest by increasing its permitted position limits.

Under current statute the CFTC must regulate these markets so that a means is provided for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair, and financially secure trading facilities; to deter and prevent price manipulation or other disruptions to market integrity; and to prevent excessive speculation or unreasonable fluctuations or unwarranted changes in the price of the commodity. Failure to do so places an unnecessary burden on interstate commerce. Currently, in my opinion, the Boards and managements of the agricultural commodity markets through self-regulation, and the CFTC through regulation, are failing in their statutory obligations to achieve these ends. Hopefully this hearing is part of a process by which the CFTC will meet its statutory obligation. Failure to do so

will result in these markets being managed and regulated for the purpose of providing investment vehicles to attract a flow of investment funds and not for price discovery and risk transfer. Although some may desire this, the Act is straightforward as to the purposes for which the markets are to be regulated.

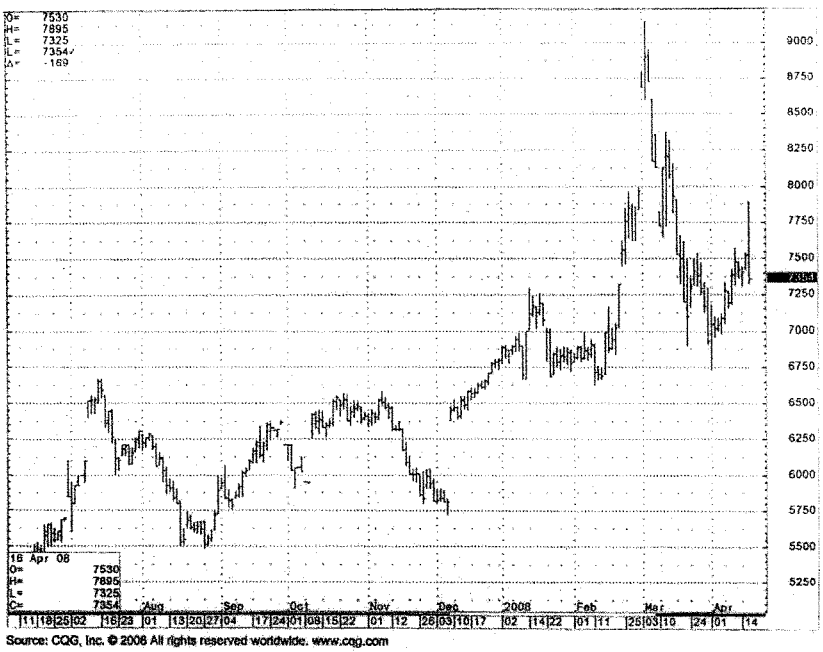
Recommendations

At the CFTC's Agricultural Markets Forum held last month, the members of AMCOT respectfully urged the Commission to implement or publicly respond to as many of the following recommendations as possible by June 1, 2008:

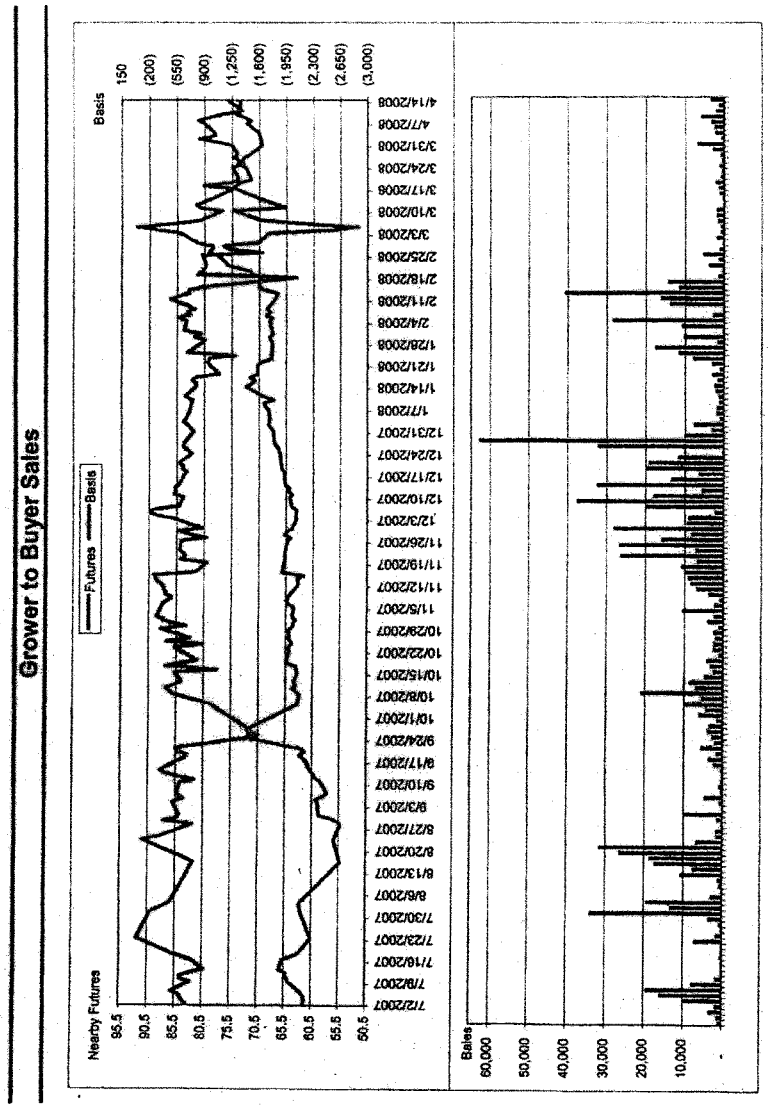
(1) Redesign the weekly CFTC position of traders report so that "Commercial" accounts be divided into two categories – hedgers involved as a commercial enterprise in the production, distribution, or consumption of the physical agricultural commodity, and hedgers not so involved.
(2) Require that any part of the position of an index fund with a hedge exemption that exceeds the dollar allocation or the percentage of funds allocated to that commodity as defined in its prospectus and recorded with the CFTC be subject to speculative position limits, speculative margin, and be reported weekly to the CFTC.
(3) Require that contract markets recognize at least three classes of traders; hedgers involved as a commercial enterprise in the production, distribution, or consumption of the physical agricultural commodity, other hedgers, and speculators. Initial margin required should be mandated so that "commercial enterprise" hedgers have the lowest, other hedgers next, and speculators the highest. The spread of initial margin between "commercial enterprise" hedgers and speculators must be significantly greater than the current spread between hedgers and speculators.
(4) Analyze what regulatory changes are necessary in order to restore a balance in agricultural contract markets between the positions of hedgers involved in production, distribution, or consumption and all other categories of traders that will make these markets meet the requirements of the Act as quoted above. This would include, but not be limited to,
    (a) Establish the maximum size of speculative limits that can be approved for a particular market on a market by market basis, and not on a "one size fits all" basis. This should result in a decrease in CFTC allowed maximum position limits for smaller contract markets.
    (b) Requiring market participants to report to the CFTC weekly the positions held in the contract market that are offsetting swap and OTC contracts, so that the CFTC can have that information available to monitor possible price disruptive behavior.
    (c) Require that daily trading range limits be established in agricultural contract markets for futures and options on futures.
(5) Require that contract markets that are organized on a for profit basis contract with an independent third party to provide their market surveillance function and that all copies of this independent third party's reports be forwarded to at least two public members of the contract market's Board.
(6) Investigate the events in the cotton futures market of February 20 – March 20, which in the opinion of this writer constituted an undue burden on interstate commerce under the Act, to determine what caused the unreasonable fluctuations and unwarranted changes in price. Since the board and management of the contract market and the Commission are statutorily bound to prevent such trading, such an investigation is necessary so that appropriate safeguards can be developed to prevent its repetition in this or some other contact market.

We similarly urge the Committee to require the Commodity Futures Trading Commission to report to Congress what steps it has taken to require the management of contract markets to operate their exchange in compliance with the Act – something we believe that the management of ICE Futures has failed to do.

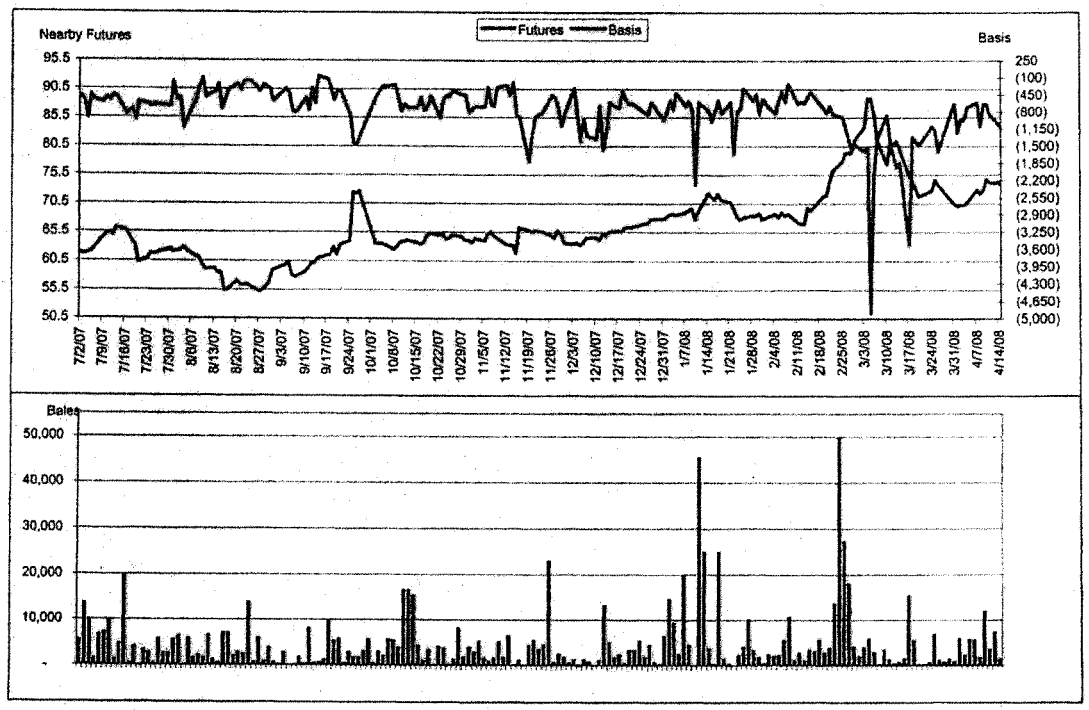
CTA - Cotton (Combined), Daily Continuation



Source: CQG, Inc. © 2008 All rights reserved worldwide. www.cqg.com


Grower to Buyer Sales
Nearby Futures
Futures
Basis
Basis
95.5
90.5
85.5
80.5
75.5
70.5
65.5
60.5
55.5
50.5
150
(200)
(550)
(900)
(1,250)
(1,600)
(1,950)
(2,300)
(2,650)
(3,000)
7/2/2007
7/9/2007
7/16/2007
7/23/2007
7/30/2007
8/6/2007
8/13/2007
8/20/2007
8/27/2007
9/3/2007
9/10/2007
9/17/2007
9/24/2007
10/1/2007
10/8/2007
10/15/2007
10/22/2007
10/29/2007
11/5/2007
11/12/2007
11/19/2007
11/26/2007
12/3/2007
12/10/2007
12/17/2007
12/24/2007
12/31/2007
1/7/2008
1/14/2008
1/21/2008
1/28/2008
2/4/2008
2/11/2008
2/18/2008
2/25/2008
3/3/2008
3/10/2008
3/17/2008
3/24/2008
3/31/2008
4/7/2008
4/14/2008
Bales
60,000
50,000
40,000
30,000
20,000
10,000

Buyer to Buyer Sales



Trade Date	Bales	Average Price	Nearby Futures	Basis	G 2 B	
7/2/07	701	0.5499	0.6193	(0.0694)	61.93	(694.00)
7/3/07	967	0.5523	0.6174	(0.0651)	61.74	(651.00)
7/5/07	3,038	0.5590	0.6198	(0.0608)	61.98	(608.00)
7/6/07	1,447	0.5739	0.6258	(0.0519)	62.58	(519.00)
7/9/07	9,266	0.5712	0.6464	(0.0752)	64.64	(752.00)
7/10/07	15,661	0.5856	0.6483	(0.0627)	64.83	(627.00)
7/11/07	19,185	0.5905	0.6527	(0.0622)	65.27	(622.00)
7/12/07	7,611	0.5759	0.6513	(0.0754)	65.13	(754.00)
7/13/07	1,382	0.5709	0.6633	(0.0924)	66.33	(924.00)
7/16/07	52	0.5811	0.6587	(0.0776)	65.87	(776.00)
7/18/07	63	0.5779	0.6299	(0.0520)	62.99	(520.00)
7/23/07	124	0.5990	0.6060	(0.0070)	60.6	(70.00)
7/31/07	337	0.6005	0.6245	(0.0240)	62.45	(240.00)
8/3/07	123	0.5790	0.6275	(0.0485)	62.75	(485.00)
8/16/07	28	0.4739	0.5523	(0.0784)	55.23	(784.00)
8/23/07	6,900	0.5514	0.5646	(0.0132)	56.46	(132.00)
8/24/07	1,409	0.5286	0.5619	(0.0333)	56.19	(333.00)
8/28/07	231	0.4760	0.5530	(0.0770)	55.3	(770.00)
8/29/07	572	0.5175	0.5573	(0.0398)	55.73	(398.00)
8/30/07	3,288	0.5123	0.5706	(0.0583)	57.06	(583.00)
8/31/07	33,644	0.5323	0.5921	(0.0598)	59.21	(598.00)
9/4/07	13,074	0.5428	0.5945	(0.0517)	59.45	(517.00)
9/5/07	19,163	0.5327	0.5977	(0.0650)	59.77	(650.00)
9/6/07	2,752	0.5249	0.5838	(0.0589)	58.38	(589.00)
9/7/07	47	0.5200	0.5775	(0.0575)	57.75	(575.00)
9/10/07	615	0.5261	0.5871	(0.0610)	58.71	(610.00)
9/11/07	934	0.5137	0.5920	(0.0783)	59.2	(783.00)
9/12/07	10,644	0.5420	0.6011	(0.0591)	60.11	(591.00)
9/13/07	7,470	0.5593	0.6020	(0.0427)	60.2	(427.00)
9/14/07	17,176	0.5725	0.6086	(0.0361)	60.86	(361.00)
9/17/07	18,439	0.5586	0.6164	(0.0578)	61.64	(578.00)
9/18/07	26,266	0.5543	0.6214	(0.0671)	62.14	(671.00)
9/19/07	31,393	0.5585	0.6276	(0.0691)	62.76	(691.00)
9/20/07	6,567	0.5623	0.6191	(0.0568)	61.91	(568.00)
9/21/07	1,425	0.5724	0.6281	(0.0557)	62.81	(557.00)
9/24/07	1,461	0.5751	0.7181	(0.1430)	71.81	(1,430.00)
9/25/07	195	0.5626	0.7222	(0.1596)	72.22	(1,596.00)
9/26/07	1,286	0.5728	0.7216	(0.1488)	72.16	(1,488.00)
9/27/07	9,361	0.5758	0.7242	(0.1484)	72.42	(1,484.00)
10/5/07	15	0.5334	0.6325	(0.0991)	63.25	(991.00)
10/8/07	571	0.5771	0.6292	(0.0521)	62.92	(521.00)
10/10/07	4,469	0.5984	0.6409	(0.0425)	64.09	(425.00)
10/11/07	296	0.5839	0.6362	(0.0523)	63.62	(523.00)
10/12/07	742	0.5770	0.6393	(0.0623)	63.93	(623.00)
10/15/07	220	0.5800	0.6335	(0.0535)	63.35	(535.00)
10/16/07	62	0.5275	0.6350	(0.1075)	63.5	(1,075.00)
10/17/07	282	0.5929	0.6352	(0.0423)	63.52	(423.00)
10/18/07	2,132	0.5822	0.6504	(0.0682)	65.04	(682.00)

Trade Date	Bales	Average Price	Nearby Futures	Basis	G 2 B	
10/19/07	3,477	0.5713	0.6531	(0.0818)	65.31	(818.00)
10/22/07	1,443	0.5872	0.6479	(0.0607)	64.79	(607.00)
10/23/07	5,399	0.5970	0.6510	(0.0540)	65.1	(540.00)
10/24/07	1,880	0.5555	0.6449	(0.0894)	64.49	(894.00)
10/25/07	2,524	0.6018	0.6447	(0.0429)	64.47	(429.00)
10/26/07	3,659	0.5759	0.6488	(0.0729)	64.88	(729.00)
10/29/07	3,243	0.6129	0.6484	(0.0355)	64.84	(355.00)
10/30/07	1,233	0.5738	0.6416	(0.0678)	64.16	(678.00)
10/31/07	5,951	0.5936	0.6409	(0.0473)	64.09	(473.00)
11/1/07	4,172	0.5995	0.6372	(0.0377)	63.72	(377.00)
11/2/07	9,568	0.6122	0.6425	(0.0303)	64.25	(303.00)
11/5/07	5,268	0.6043	0.6400	(0.0357)	64	(357.00)
11/6/07	20,877	0.6126	0.6507	(0.0381)	65.07	(381.00)
11/7/07	6,922	0.6094	0.6537	(0.0443)	65.37	(443.00)
11/8/07	8,392	0.6012	0.6506	(0.0494)	65.06	(494.00)
11/9/07	4,500	0.6050	0.6471	(0.0421)	64.71	(421.00)
11/12/07	2,320	0.5957	0.6330	(0.0373)	63.3	(373.00)
11/13/07	3,054	0.6013	0.6323	(0.0310)	63.23	(310.00)
11/14/07	4,065	0.6047	0.6333	(0.0286)	63.33	(286.00)
11/15/07	863	0.5949	0.6216	(0.0267)	62.16	(267.00)
11/16/07	2,437	0.5826	0.6620	(0.0794)	66.2	(794.00)
11/19/07	2,253	0.5642	0.6587	(0.0945)	65.87	(945.00)
11/20/07	1,874	0.5959	0.6560	(0.0601)	65.6	(601.00)
11/21/07	2,411	0.5902	0.6573	(0.0671)	65.73	(671.00)
11/23/07	935	0.5968	0.6560	(0.0592)	65.6	(592.00)
11/26/07	3,792	0.5903	0.6523	(0.0620)	65.23	(620.00)
11/27/07	2,232	0.5516	0.6454	(0.0938)	64.54	(938.00)
11/28/07	10,334	0.5863	0.6573	(0.0710)	65.73	(710.00)
11/29/07	2,121	0.5959	0.6534	(0.0575)	65.34	(575.00)
11/30/07	782	0.5549	0.6440	(0.0891)	64.4	(891.00)
12/3/07	3,561	0.5853	0.6362	(0.0509)	63.62	(509.00)
12/4/07	6,724	0.6069	0.6370	(0.0301)	63.7	(301.00)
12/5/07	8,303	0.6141	0.6358	(0.0217)	63.58	(217.00)
12/6/07	8,923	0.6086	0.6355	(0.0269)	63.55	(269.00)
12/7/07	9,476	0.5862	0.6444	(0.0582)	64.44	(582.00)
12/10/07	10,616	0.5842	0.6483	(0.0641)	64.83	(641.00)
12/11/07	6,607	0.5911	0.6432	(0.0521)	64.32	(521.00)
12/12/07	26,216	0.5970	0.6511	(0.0541)	65.11	(541.00)
12/13/07	6,959	0.5955	0.6485	(0.0530)	64.85	(530.00)
12/14/07	26,500	0.5979	0.6561	(0.0582)	65.61	(582.00)
12/17/07	15,612	0.5935	0.6584	(0.0649)	65.84	(649.00)
12/18/07	8,078	0.5885	0.6566	(0.0681)	65.66	(681.00)
12/19/07	27,945	0.5994	0.6626	(0.0632)	66.26	(632.00)
12/20/07	9,160	0.6005	0.6639	(0.0634)	66.39	(634.00)
12/21/07	8,883	0.6060	0.6649	(0.0589)	66.49	(589.00)
12/24/07	2,013	0.5915	0.6665	(0.0750)	66.65	(750.00)
12/26/07	19,422	0.6059	0.6701	(0.0642)	67.01	(642.00)
12/27/07	37,402	0.6110	0.6760	(0.0650)	67.6	(650.00)

Trade Date	Bales	Average Price	Nearby Futures	Basis	G 2 B	
12/28/07	17,665	0.6099	0.6776	(0.0677)	67.76	(677.00)
12/31/07	5,412	0.6014	0.6783	(0.0769)	67.83	(769.00)
1/2/08	32,197	0.6178	0.6869	(0.0691)	68.69	(691.00)
1/3/08	13,172	0.6228	0.6869	(0.0641)	68.69	(641.00)
1/4/08	6,148	0.6180	0.6852	(0.0672)	68.52	(672.00)
1/7/08	19,586	0.6154	0.6878	(0.0724)	68.78	(724.00)
1/8/08	19,044	0.6205	0.6939	(0.0734)	69.39	(734.00)
1/9/08	11,528	0.6211	0.6954	(0.0743)	69.54	(743.00)
1/10/08	193	0.6029	0.6780	(0.0751)	67.8	(751.00)
1/11/08	32,058	0.6298	0.6958	(0.0660)	69.58	(660.00)
1/14/08	62,793	0.6490	0.7285	(0.0795)	72.85	(795.00)
1/15/08	9,366	0.6389	0.7190	(0.0801)	71.9	(801.00)
1/16/08	2,897	0.6369	0.7119	(0.0750)	71.19	(750.00)
1/17/08	7,537	0.6412	0.7210	(0.0798)	72.1	(798.00)
1/18/08	760	0.5987	0.7082	(0.1095)	70.82	(1,095.00)
1/21/08	1,611	0.6116	0.7079	(0.0963)	70.79	(963.00)
1/22/08	1,611	0.6051	0.6999	(0.0948)	69.99	(948.00)
1/23/08	982	0.5839	0.6815	(0.0976)	68.15	(976.00)
1/24/08	1,080	0.5532	0.6823	(0.1291)	68.23	(1,291.00)
1/25/08	1,985	0.6130	0.6821	(0.0691)	68.21	(691.00)
1/28/08	2,260	0.5940	0.6808	(0.0868)	68.08	(868.00)
1/29/08	1,397	0.5918	0.6833	(0.0915)	68.33	(915.00)
1/30/08	2,850	0.6074	0.6859	(0.0785)	68.59	(785.00)
1/31/08	889	0.5931	0.6793	(0.0862)	67.93	(862.00)
2/1/08	2,915	0.6164	0.6818	(0.0654)	68.18	(654.00)
2/4/08	7,708	0.6181	0.6858	(0.0677)	68.58	(677.00)
2/5/08	11,471	0.6226	0.6806	(0.0580)	68.06	(580.00)
2/6/08	17,407	0.6199	0.6915	(0.0716)	69.15	(716.00)
2/7/08	1,476	0.6139	0.6839	(0.0700)	68.39	(700.00)
2/8/08	10,162	0.6130	0.6906	(0.0776)	69.06	(776.00)
2/11/08	232	0.6289	0.6762	(0.0473)	67.62	(473.00)
2/13/08	10,647	0.6001	0.6707	(0.0706)	67.07	(706.00)
2/14/08	28,253	0.6249	0.6961	(0.0712)	69.61	(712.00)
2/15/08	2,540	0.6156	0.7056	(0.0900)	70.56	(900.00)
2/18/08	33	0.4939	0.7018	(0.2079)	70.18	(2,079.00)
2/19/08	13,585	0.6345	0.7172	(0.0827)	71.72	(827.00)
2/20/08	15,999	0.6338	0.7219	(0.0881)	72.19	(881.00)
2/21/08	40,618	0.6526	0.7438	(0.0912)	74.38	(912.00)
2/22/08	11,411	0.6698	0.7619	(0.0921)	76.19	(921.00)
2/25/08	14,150	0.6919	0.7798	(0.0879)	77.98	(879.00)
2/26/08	1,246	0.6330	0.7966	(0.1636)	79.66	(1,636.00)
2/27/08	88	0.6700	0.7910	(0.1210)	79.1	(1,210.00)
2/28/08	3,726	0.6735	0.7889	(0.1154)	78.89	(1,154.00)
2/29/08	1,131	0.6585	0.8166	(0.1581)	81.66	(1,581.00)
3/3/08	5,168	0.6759	0.8486	(0.1727)	84.86	(1,727.00)
3/4/08	924	0.6340	0.8886	(0.2546)	88.86	(2,546.00)
3/5/08	169	0.6401	0.9274	(0.2873)	92.74	(2,873.00)
3/6/08	1,660	0.6374	0.8582	(0.2208)	85.82	(2,208.00)

Trade Date	Bales	Average Price	Nearby Futures	Basis	G 2 B	
3/7/08	701	0.6509	0.8128	(0.1619)	81.28	(1,619.00)
3/10/08	681	0.6458	0.7728	(0.1270)	77.28	(1,270.00)
3/11/08	1,455	0.6181	0.8121	(0.1940)	81.21	(1,940.00)
3/12/08	1,744	0.6377	0.8194	(0.1817)	81.94	(1,817.00)
3/14/08	1,709	0.6314	0.7895	(0.1581)	78.95	(1,581.00)
3/17/08	30	0.6235	0.7530	(0.1295)	75.3	(1,295.00)
3/18/08	278	0.6588	0.7481	(0.0893)	74.81	(893.00)
3/19/08	975	0.6155	0.7399	(0.1244)	73.99	(1,244.00)
3/20/08	1,182	0.5861	0.7200	(0.1339)	72	(1,339.00)
3/24/08	2,058	0.6045	0.7303	(0.1258)	73.03	(1,258.00)
3/25/08	752	0.6029	0.7438	(0.1409)	74.38	(1,409.00)
3/26/08	485	0.6022	0.7371	(0.1349)	73.71	(1,349.00)
3/27/08	1,020	0.6050	0.7332	(0.1282)	73.32	(1,282.00)
3/28/08	352	0.5904	0.7231	(0.1327)	72.31	(1,327.00)
3/31/08	740	0.5756	0.7004	(0.1248)	70.04	(1,248.00)
4/1/08	2,765	0.5988	0.7009	(0.1021)	70.09	(1,021.00)
4/2/08	6,718	0.6182	0.7019	(0.0837)	70.19	(837.00)
4/3/08	558	0.6004	0.7046	(0.1042)	70.46	(1,042.00)
4/4/08	2,173	0.6025	0.7052	(0.1027)	70.52	(1,027.00)
4/7/08	2,328	0.6379	0.7277	(0.0898)	72.77	(898.00)
4/8/08	3,189	0.6381	0.7202	(0.0821)	72.02	(821.00)
4/9/08	5,783	0.6338	0.7329	(0.0991)	73.29	(991.00)
4/10/08	1,928	0.6316	0.7476	(0.1160)	74.76	(1,160.00)
4/11/08	1,279	0.6022	0.7397	(0.1375)	73.97	(1,375.00)
4/14/08	3,307	0.6185	0.7406	(0.1221)	74.06	(1,221.00)

Trade Date	Bales	Average Price	Nearby Futures	Basis	B 2 B	
7/2/07	5,480	0.5688	0.6185	(0.0497)	61.85	(497.00)
7/3/07	13,569	0.5589	0.6164	(0.0575)	61.64	(575.00)
7/4/07	10,000	0.5234	0.6175	(0.0941)	61.75	(941.00)
7/5/07	1,287	0.5735	0.6200	(0.0465)	62	(465.00)
7/6/07	6,558	0.5692	0.6256	(0.0564)	62.56	(564.00)
7/9/07	7,084	0.5842	0.6451	(0.0609)	64.51	(609.00)
7/10/07	9,473	0.6001	0.6520	(0.0519)	65.2	(519.00)
7/11/07	1,175	0.5950	0.6525	(0.0575)	65.25	(575.00)
7/12/07	4,656	0.6023	0.6500	(0.0477)	65	(477.00)
7/13/07	19,722	0.6119	0.6619	(0.0500)	66.19	(500.00)
7/16/07	358	0.5715	0.6580	(0.0865)	65.8	(865.00)
7/18/07	3,933	0.5636	0.6387	(0.0751)	63.87	(751.00)
7/19/07	15	0.5335	0.6307	(0.0972)	63.07	(972.00)
7/20/07	3,211	0.5410	0.6025	(0.0615)	60.25	(615.00)
7/23/07	2,615	0.5437	0.6087	(0.0650)	60.87	(650.00)
7/24/07	302	0.5472	0.6170	(0.0698)	61.7	(698.00)
7/25/07	5,741	0.5513	0.6164	(0.0651)	61.64	(651.00)
7/30/07	2,588	0.5555	0.6247	(0.0692)	62.47	(692.00)
7/31/07	2,495	0.6000	0.6200	(0.0200)	62	(200.00)
8/1/07	5,533	0.5653	0.6214	(0.0561)	62.14	(561.00)
8/2/07	6,247	0.5691	0.6219	(0.0528)	62.19	(528.00)
8/3/07	40	0.5150	0.6275	(0.1125)	62.75	(1,125.00)
8/7/07	5,840	0.5569	0.6127	(0.0558)	61.27	(558.00)
8/8/07	1,489	0.5805	0.6118	(0.0313)	61.18	(313.00)
8/9/07	2,056	0.5881	0.6004	(0.0123)	60.04	(123.00)
8/10/07	1,516	0.5400	0.5900	(0.0500)	59	(500.00)
8/13/07	6,531	0.5519	0.5910	(0.0391)	59.1	(391.00)
8/14/07	1,165	0.5597	0.5835	(0.0238)	58.35	(238.00)
8/15/07	452	0.5116	0.5841	(0.0725)	58.41	(725.00)
8/16/07	7,041	0.4996	0.5536	(0.0540)	55.36	(540.00)
8/17/07	6,986	0.5185	0.5550	(0.0365)	55.5	(365.00)
8/20/07	2,035	0.5468	0.5700	(0.0232)	57	(232.00)
8/21/07	2,774	0.5262	0.5629	(0.0367)	56.29	(367.00)
8/22/07	2,446	0.5449	0.5631	(0.0182)	56.31	(182.00)
8/23/07	13,764	0.5469	0.5645	(0.0176)	56.45	(176.00)
8/24/07	601	0.5425	0.5610	(0.0185)	56.1	(185.00)
8/27/07	5,898	0.5137	0.5519	(0.0382)	55.19	(382.00)
8/28/07	853	0.5305	0.5550	(0.0245)	55.5	(245.00)
8/30/07	3,816	0.5341	0.5683	(0.0342)	56.83	(342.00)
8/31/07	574	0.5300	0.5878	(0.0578)	58.78	(578.00)
9/4/07	191	0.5650	0.5980	(0.0330)	59.8	(330.00)
9/5/07	2,771	0.5613	0.6030	(0.0417)	60.3	(417.00)
9/6/07	33	0.4990	0.5791	(0.0801)	57.91	(801.00)
9/7/07	192	0.4962	0.5772	(0.0810)	57.72	(810.00)
9/10/07	1,670	0.5337	0.5853	(0.0516)	58.53	(516.00)
9/11/07	265	0.5145	0.5915	(0.0770)	59.15	(770.00)
9/12/07	8,036	0.5684	0.6005	(0.0321)	60.05	(321.00)
9/13/07	398	0.5380	0.6011	(0.0631)	60.11	(631.00)

Trade Date	Bales	Average Price	Nearby Futures	Basis	B 2 B	
9/14/07	564	0.6032	0.6102	(0.0070)	61.02	(70.00)
9/17/07	1,109	0.6009	0.6143	(0.0134)	61.43	(134.00)
9/18/07	9,598	0.5825	0.6155	(0.0330)	61.55	(330.00)
9/19/07	5,255	0.5729	0.6289	(0.0560)	62.89	(560.00)
9/20/07	5,785	0.5789	0.6154	(0.0365)	61.54	(365.00)
9/21/07	370	0.5944	0.6334	(0.0390)	63.34	(390.00)
9/24/07	2,872	0.5507	0.6390	(0.0883)	63.9	(883.00)
9/25/07	1,734	0.5805	0.7240	(0.1435)	72.4	(1,435.00)
9/26/07	1,738	0.5738	0.7217	(0.1479)	72.17	(1,479.00)
9/27/07	2,984	0.5966	0.7259	(0.1293)	72.59	(1,293.00)
10/2/07	5,750	0.5848	0.6347	(0.0499)	63.47	(499.00)
10/4/07	440	0.6050	0.6346	(0.0296)	63.46	(296.00)
10/8/07	2,974	0.5993	0.6246	(0.0253)	62.46	(253.00)
10/10/07	1,969	0.5586	0.6380	(0.0794)	63.8	(794.00)
10/11/07	5,651	0.5735	0.6382	(0.0647)	63.82	(647.00)
10/12/07	5,378	0.5684	0.6407	(0.0723)	64.07	(723.00)
10/15/07	3,825	0.5644	0.6368	(0.0724)	63.68	(724.00)
10/16/07	16,604	0.5828	0.6342	(0.0514)	63.42	(514.00)
10/17/07	16,555	0.5578	0.6354	(0.0776)	63.54	(776.00)
10/18/07	15,334	0.5775	0.6477	(0.0702)	64.77	(702.00)
10/19/07	4,388	0.6042	0.6532	(0.0490)	65.32	(490.00)
10/22/07	910	0.5546	0.6487	(0.0941)	64.87	(941.00)
10/23/07	3,370	0.5957	0.6514	(0.0557)	65.14	(557.00)
10/24/07	111	0.5950	0.6425	(0.0475)	64.25	(475.00)
10/25/07	4,000	0.5954	0.6444	(0.0490)	64.44	(490.00)
10/26/07	3,634	0.6111	0.6488	(0.0377)	64.88	(377.00)
10/29/07	176	0.6022	0.6475	(0.0453)	64.75	(453.00)
10/30/07	1,217	0.5945	0.6409	(0.0464)	64.09	(464.00)
10/31/07	8,162	0.5596	0.6407	(0.0811)	64.07	(811.00)
11/1/07	1,746	0.5612	0.6366	(0.0754)	63.66	(754.00)
11/2/07	3,944	0.5745	0.6437	(0.0692)	64.37	(692.00)
11/5/07	2,780	0.5694	0.6394	(0.0700)	63.94	(700.00)
11/6/07	5,132	0.6189	0.6492	(0.0303)	64.92	(303.00)
11/7/07	1,463	0.5908	0.6555	(0.0647)	65.55	(647.00)
11/8/07	776	0.5807	0.6489	(0.0682)	64.89	(682.00)
11/9/07	1,499	0.6143	0.6445	(0.0302)	64.45	(302.00)
11/12/07	5,118	0.6084	0.6337	(0.0253)	63.37	(253.00)
11/13/07	1,642	0.5853	0.6322	(0.0469)	63.22	(469.00)
11/14/07	6,388	0.6120	0.6324	(0.0204)	63.24	(204.00)
11/15/07	51	0.5315	0.6184	(0.0869)	61.84	(869.00)
11/16/07	1,016	0.5715	0.6631	(0.0916)	66.31	(916.00)
11/19/07	61	0.4774	0.6588	(0.1814)	65.88	(1,814.00)
11/20/07	4,427	0.5325	0.6546	(0.1221)	65.46	(1,221.00)
11/21/07	5,492	0.5680	0.6579	(0.0899)	65.79	(899.00)
11/23/07	3,493	0.5736	0.6560	(0.0824)	65.6	(824.00)
11/26/07	4,436	0.6018	0.6494	(0.0476)	64.94	(476.00)
11/27/07	22,877	0.5951	0.6444	(0.0493)	64.44	(493.00)
11/28/07	570	0.5868	0.6571	(0.0703)	65.71	(703.00)

Trade Date	Bales	Average Price	Nearby Futures	Basis	B 2 B	
11/29/07	2,380	0.5430	0.6511	(0.1081)	65.11	(1,081.00)
11/30/07	1,718	0.5514	0.6367	(0.0853)	63.67	(853.00)
12/3/07	420	0.6025	0.6345	(0.0320)	63.45	(320.00)
12/4/07	1,176	0.5489	0.6373	(0.0884)	63.73	(884.00)
12/5/07	56	0.4928	0.6325	(0.1397)	63.25	(1,397.00)
12/6/07	1,206	0.5423	0.6376	(0.0953)	63.76	(953.00)
12/7/07	721	0.5157	0.6450	(0.1293)	64.5	(1,293.00)
12/10/07	34	0.5100	0.6461	(0.1361)	64.61	(1,361.00)
12/11/07	1,018	0.5727	0.6413	(0.0686)	64.13	(686.00)
12/12/07	13,140	0.4944	0.6520	(0.1576)	65.2	(1,576.00)
12/13/07	5,004	0.5258	0.6490	(0.1232)	64.9	(1,232.00)
12/14/07	1,645	0.5937	0.6554	(0.0617)	65.54	(617.00)
12/17/07	2,345	0.5849	0.6573	(0.0724)	65.73	(724.00)
12/18/07	449	0.6172	0.6561	(0.0389)	65.61	(389.00)
12/19/07	3,209	0.6100	0.6633	(0.0533)	66.33	(533.00)
12/20/07	3,223	0.6004	0.6636	(0.0632)	66.36	(632.00)
12/21/07	5,324	0.6008	0.6635	(0.0627)	66.35	(627.00)
12/26/07	1,789	0.5851	0.6710	(0.0859)	67.1	(859.00)
12/27/07	4,422	0.6164	0.6773	(0.0609)	67.73	(609.00)
12/28/07	620	0.6087	0.6780	(0.0693)	67.8	(693.00)
12/31/07	194	0.5803	0.6780	(0.0977)	67.8	(977.00)
1/2/08	6,408	0.6281	0.6856	(0.0575)	68.56	(575.00)
1/3/08	14,507	0.6118	0.6863	(0.0745)	68.63	(745.00)
1/4/08	9,294	0.6428	0.6850	(0.0422)	68.5	(422.00)
1/7/08	2,385	0.6212	0.6889	(0.0677)	68.89	(677.00)
1/8/08	19,858	0.6340	0.6927	(0.0587)	69.27	(587.00)
1/9/08	4,350	0.6187	0.6959	(0.0772)	69.59	(772.00)
1/10/08	3	0.4500	0.6772	(0.2272)	67.72	(2,272.00)
1/11/08	45,389	0.6301	0.6913	(0.0612)	69.13	(612.00)
1/14/08	24,817	0.6469	0.7231	(0.0762)	72.31	(762.00)
1/15/08	3,730	0.6170	0.7171	(0.1001)	71.71	(1,001.00)
1/16/08	189	0.6319	0.7118	(0.0799)	71.18	(799.00)
1/17/08	24,889	0.6646	0.7215	(0.0569)	72.15	(569.00)
1/18/08	1,287	0.6294	0.7117	(0.0823)	71.17	(823.00)
1/21/08	256	0.6476	0.7079	(0.0603)	70.79	(603.00)
1/22/08	17	0.5300	0.6965	(0.1665)	69.65	(1,665.00)
1/23/08	2,183	0.6040	0.6826	(0.0786)	68.26	(786.00)
1/24/08	3,996	0.6021	0.6766	(0.0745)	67.66	(745.00)
1/25/08	10,083	0.6475	0.6800	(0.0325)	68	(325.00)
1/28/08	3,210	0.6273	0.6842	(0.0569)	68.42	(569.00)
1/29/08	1,728	0.6386	0.6835	(0.0449)	68.35	(449.00)
1/30/08	361	0.6037	0.6879	(0.0842)	68.79	(842.00)
1/31/08	2,420	0.6220	0.6770	(0.0550)	67.7	(550.00)
2/1/08	1,988	0.6177	0.6806	(0.0629)	68.06	(629.00)
2/4/08	2,213	0.6036	0.6870	(0.0834)	68.7	(834.00)
2/5/08	5,589	0.6236	0.6803	(0.0567)	68.03	(567.00)
2/6/08	10,558	0.6501	0.6894	(0.0393)	68.94	(393.00)
2/7/08	1,051	0.6253	0.6836	(0.0583)	68.36	(583.00)

Trade Date	Bales	Average Price	Nearby Futures	Basis	B 2 B	
2/8/08	2,704	0.6632	0.6866	(0.0234)	68.66	(234.00)
2/11/08	1,035	0.6088	0.6722	(0.0634)	67.22	(634.00)
2/12/08	3,413	0.6099	0.6691	(0.0592)	66.91	(592.00)
2/13/08	3,055	0.6069	0.6691	(0.0622)	66.91	(622.00)
2/14/08	5,528	0.6477	0.6978	(0.0501)	69.78	(501.00)
2/15/08	2,628	0.6521	0.6920	(0.0399)	69.2	(399.00)
2/19/08	3,846	0.6464	0.7181	(0.0717)	71.81	(717.00)
2/20/08	13,573	0.6354	0.7183	(0.0829)	71.83	(829.00)
2/21/08	49,870	0.6753	0.7434	(0.0681)	74.34	(681.00)
2/22/08	27,200	0.6782	0.7630	(0.0848)	76.3	(848.00)
2/25/08	17,941	0.6875	0.7786	(0.0911)	77.86	(911.00)
2/26/08	4,004	0.6804	0.7933	(0.1129)	79.33	(1,129.00)
2/28/08	1,889	0.6339	0.7933	(0.1594)	79.33	(1,594.00)
2/29/08	3,900	0.6672	0.8142	(0.1470)	81.42	(1,470.00)
3/3/08	5,773	0.6775	0.8384	(0.1609)	83.84	(1,609.00)
3/4/08	2,821	0.7357	0.8886	(0.1529)	88.86	(1,529.00)
3/5/08	166	0.4000	0.8887	(0.4887)	88.87	(4,887.00)
3/6/08	3,359	0.6560	0.8600	(0.2040)	86	(2,040.00)
3/7/08	1,295	0.6794	0.8128	(0.1334)	81.28	(1,334.00)
3/10/08	344	0.6850	0.7728	(0.0878)	77.28	(878.00)
3/11/08	663	0.6684	0.8119	(0.1435)	81.19	(1,435.00)
3/12/08	1,452	0.6373	0.8085	(0.1712)	80.85	(1,712.00)
3/13/08	15,318	0.6200	0.8132	(0.1932)	81.32	(1,932.00)
3/14/08	5,456	0.6165	0.8007	(0.1842)	80.07	(1,842.00)
3/17/08	123	0.4018	0.7530	(0.3512)	75.3	(3,512.00)
3/18/08	225	0.6110	0.7428	(0.1318)	74.28	(1,318.00)
3/20/08	606	0.5691	0.7175	(0.1484)	71.75	(1,484.00)
3/24/08	6,772	0.6167	0.7271	(0.1104)	72.71	(1,104.00)
3/25/08	1,137	0.6289	0.7463	(0.1174)	74.63	(1,174.00)
3/26/08	662	0.5770	0.7376	(0.1606)	73.76	(1,606.00)
3/31/08	1,368	0.6412	0.7049	(0.0637)	70.49	(637.00)
4/1/08	838	0.5775	0.7005	(0.1230)	70.05	(1,230.00)
4/2/08	5,937	0.6045	0.7019	(0.0974)	70.19	(974.00)
4/3/08	2,257	0.6063	0.7027	(0.0964)	70.27	(964.00)
4/4/08	5,716	0.6372	0.7068	(0.0696)	70.68	(696.00)
4/7/08	5,592	0.6676	0.7288	(0.0612)	72.88	(612.00)
4/8/08	1,719	0.6121	0.7219	(0.1098)	72.19	(1,098.00)
4/9/08	11,834	0.6646	0.7290	(0.0644)	72.9	(644.00)
4/10/08	3,553	0.6838	0.7477	(0.0639)	74.77	(639.00)
4/11/08	7,279	0.6568	0.7417	(0.0849)	74.17	(849.00)
4/14/08	1,375	0.6324	0.7405	(0.1081)	74.05	(1,081.00)

528 Billy Sunday Road, Suite 100
Ames, IA 50010-2508
515-292-2000
nfo@nfo.org

STATEMENT OF

EUGENE PAUL POLICY ANALYST

NATIONAL FARMERS ORGANIZATION

528 BILLY SUNDAY ROAD, SUITE 100

AMES IA 50010

515-292-2000

COMMITTEE OF AGRICULTURE

US HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON GENERAL FARM

COMMODITIES AND RISK MANAGEMENT

May 15, 2008

Statement on behalf of the National Farmers Organization
528 Billy Sunday Road, Suite 100
Ames, Iowa 50010

The National Farmers Organization represents independent producers nationwide in negotiating contracts and other terms of trade for grain, livestock and dairy. We are in the marketplace doing so on a daily basis. The specific purpose is to help independent producers extract the dollars they need to cashflow their operations, pay their expenses and earn a living from what they produce and sell.

We define an independent producer as one who with his or her family resides on their farm, provides day to day management, decision making, controls the marketing of the production, whose capital is at risk, and owns or wants to own that business.

As an organization that serves as a marketing agent for farmers, the dilemma that is created by not being able to forward contract grain is very difficult. Staggering increases in the prices of fertilizer, pesticides, diesel fuel, seed, land rents and other input costs for spring planting leaves a farmer at risk of lower priced commodities next year unless his is able to forward contract to protect a profitable level. There is even greater concern that for 2009 and 2010 crop years, input costs will not decrease, but with the world responding to the high prices on the Chicago Board of Trade (CBOT) by planting record acres that the prices will come down and farmers will have missed an opportunity to capture prices high enough to lock in their cost of production plus a reasonable profit.

We feel the CBOT's grain contracts are no longer accurately providing the price discovery mechanism that has been relied upon by farmers for many years. The fundamentals of supply and demand are now being reflected in the basis rather than in the futures prices. This creates the convergence problem that was experienced earlier this year.

Index Funds testifying at a CFTC Agriculture Forum in April did not seem to care what the fundamentals of the grain markets were. One witness noted that an addition of 5% commodity investments by funds reduces volatility for the fund. Another witness stated that slowly increasing commodities as a percentage of a portfolio was a great performing asset in the portfolio. These new market participants have no commercial interest in the underlying commodity and add nothing positive to the important price discovery function of futures markets. These new market participants have a large impact on trading volume as shown below.

- From 10/1/2007 to 2/11/2008 the July 2008 Corn contract on the CBOT (CN8) generally traded between 850 and 3700 contracts per day. On 2/12/08 volume jumped to 11,581. 2/29/08 was 34,199 contracts traded; 3/31/08 was 98,683 contracts traded, 4/29/08 201,586 contracts traded, or

> 1,007,930,000 bushels of corn. According to the USDA April Supply and Demand Report, carryout of 2007/08-crop corn is 1,283,000,000 bushels and practically the whole amount was traded on 4/29/08. With the lack of transparency in the market place, how do we know who is trading all these contracts? Can we be assured that someone is not trying to corner the market? With lack of transparency and electronic trading platforms, grains, oil and other commodities are at a risk of manipulation by foreign interests, as well.

The CBOT was established to be the price discovery mechanism to offer farmers and end users price protection. With a minimum percentage of the trading on the CBOT from either farmers or end users, how can we be assured that commodity prices accurately reflect supply and demand? And with so many buyers now not offering any opportunity for farmers to protect their prices, it becomes a "great performing asset" for pension funds instead of a risk management and priced discovery mechanism for agriculture.

More transparency and position limits are tools that could help stabilize the market and help convergence. Also, we must ensure that all "hedgers" truly hold a cash grain position.

In order to facilitate forward contracting for farmers during volatile markets, the USDA, administered by the Commodity Credit Corporation (CCC) that would be similar to the CCC loan program for farmers, could implement a loan program for grain elevators and end users. When an end user purchases grain on a forward contract from a farmer, the purchase contract, signed by the elevator and the farmer, could serve as documentation to allow hedge accounts to be financed by the CCC until the contract delivery period.

To minimize convergence issues and margin requirements, the USDA may consider recommending the use of the National Index Futures traded on the Minneapolis Grain Exchange. According to a research study by Sparks Commodities, Inc., there is a much greater correlation between cash prices reflected by the National Index Futures for most of the Midwest Grain Producing areas than there is for the CBOT.

The main concern is that farmers and end users are able to use the CBOT for risk management in volatile markets. When opportunities exist to lock in the cost of production plus a reasonable profit, the CBOT was supposed to be the tool for agriculture to utilize for that purpose. A strong agricultural economy is a necessity to underpin the US economy, the CBOT is the tool to ensure our strength.

Mr. Chairman, the Agriculture Committee has jurisdiction over both the USDA and the CFTC and we feel the solutions to problems caused by excess volatility, lack of convergence and devastating margin calls can be found through

more control on speculation, more transparency and tighter position limits.

Thank you for the opportunity to bring you this message for National Farmers Organization (NFO) Members.

To: Acting Chairman Walter Lukken

From: House Agriculture Committee

Date: May 22, 2008

Re: Supplemental Questions for Hearing to review the source of dramatic movements in commodity markets

Please find enclosed a list of additional questions the following members would like answered by Mr. Jeff Harris, Chief Economist, and Mr. John Fenton, Deputy Director, Market Surveillance Section, in writing for the record. Feel free to contact Committee staff if you have any questions.

Questions from Subcommittee Chairman Bob Etheridge

1. **Senators Levin and Feinstein recently introduced the Oil Trading Transparency Act. This bill, as described, would require foreign boards of trade that allow trading of energy commodities physically delivered in the U.S. to match the position limits or accountability levels of CFTC regulated exchanges for such energy commodities.**

   As I understand it, the bill doesn't give the Commission authority over these exchanges per se – Congress does not have that power – but if a foreign board of trade did not comply with this requirement, the CFTC could deny a foreign board of trade the relief from meeting the obligations of the Commodity Exchange Act that it currently enjoys, thereby forcing the CFTC to close terminals in the U.S. that provide direct access to the foreign board of trade's market. Please answer the listed questions about this Act and its potential consequences.

   - **Assuming it became law and foreign exchanges refused to comply and the CFTC closed the terminals, what would be the reaction overseas?**

   It is difficult to predict what would be the reaction overseas in this hypothetical situation. In the worst-case scenario, the regulator of the foreign board of trade could adopt retaliatory measures against U.S. futures exchanges and the European Union might initiate discussions on an EU-wide response (e.g., the imposition of retaliatory measures or elevating the matter to a trade dispute).

   However, the intensity of any reaction likely would depend on whether the U.S. regulatory requirement is viewed as serving a demonstrably valid U.S. regulatory purpose (*e.g.,* market integrity in the context of a contract on a foreign board of trade that is "linked" to the settlement price of a contract traded on a U.S. exchange). With a

credible demonstration that the imposition of "matched" speculative position limits or accountability levels at the foreign exchange serves a valid U.S. regulatory purpose, a foreign government may recognize the restrictions as an appropriate, rather than an anti-competitive, application of U.S. law.

- **Could American exchanges, both futures and equity markets, which have terminals overseas see retaliatory action taken against them?**

As discussed in response to the foregoing question, it is conceivable that unilateral U.S. actions could provoke retaliatory moves abroad against United States futures exchanges, which operate globally. Indeed, during the Commission's 2006 reconsideration of its foreign board of trade program, some United States futures exchanges warned the Commission against taking actions that could result in retaliatory moves abroad.

For example, the Chicago Mercantile Exchange (CME) voiced a concern about potential regulation by foreign regulators of its Eurodollar futures and options contract and its European heating Degree Day futures contract (which is based on temperatures in Berlin and Essen).

Similarly, a June 26, 2006 letter submitted by the New York Board of Trade (NYBOT) warned that premising regulation by the U.S. of a foreign market based upon the origin of the underlying commodity, primary location of the cash market or location of delivery points, would be arbitrary and invite reciprocal regulatory moves.

As discussed in response to the foregoing question, though, it is not clear that any such retaliation would result from a U.S. policy that serves a demonstrably valid U.S. regulatory purpose (*e.g.*, market integrity in the context of a contract on a foreign board of trade that is "linked" to the settlement price of a contract traded on a U.S. exchange).

- **Do American exchanges trade energy commodity contracts – or other commodity contracts for that mater – which are delivered in other nations?**

Several U.S. futures exchanges list futures contracts (and options on those futures contracts) based on commodities that are delivered or settle in foreign countries. For example:

- New York Mercantile Exchange (NYMEX) lists a contract on Russian Blend Crude Export Oil that calls for delivery Free On Board (F.O.B.) at the port of Primorsk, Russia, located on the Baltic Sea. (We understand that there has not been any material trading on this contract.)

- NYMEX Singapore 380c Fuel Oil delivers F.O.B. at the seller's ex-shore facility in Singapore.

- NYMEX European Union Allowance (EUA) Futures Contract – calls for delivery at the UK Emissions Trading registry.

- ICE Futures US (formerly NYBOT) Coffee "C" – allows for warehouse delivery via electronic warehouse receipts in Antwerp, Hamburg, Bremen and Barcelona as well as New York, New Orleans, Miami and Houston.

- ICE Futures US (formerly NYBOT) Sugar No. 11 – allows FOB delivery in any port that meets the draft and vessel requirements in the country of origin; sugar grown in the following countries is eligible for delivery – Argentina, Australia, Barbados, Belize, Brazil, Honduras, Colombia, Costa Rica, Dominican Republic, El Salvador, Ecuador, Fiji Islands, French Antilles, Guatemala, India, Jamaica, Malawi, Mauritius, Mexico, Mozambique, Nicaragua, Peru, Republic of the Philippines, South Africa, Swaziland, Taiwan, Thailand, Trinidad, United States and Zimbabwe.

- ICE Futures US (formerly NYBOT) Robusta Coffee – allows for warehouse delivery via electronic warehouse receipts in Antwerp, Hamburg, Bremen, Barcelona and Trieste as well as New York, New Orleans, Miami and Houston.

- The Chicago Board of Trade (CBOT) lists South American Soybean futures which deliver in Brazil. (However, this contract has no open interest and has not traded since October 2006.)

2. **Mr. Harris—At the hearing, you answered my question about whether funds could be having a dampening effect on market moves or could be imposing a floor on commodity prices by saying "that is one possibility that we are trying to assess here," which indicates to me that you have not made a determination yet if this dampening effect or price floor is occurring or not. You proceeded to explain the process of looking at price changes and position changes by various groups of traders. What are the telltale signs that this dampening effect or price floor exits, and when do you expect to complete your analysis so you can provide a definitive answer to my original question?**

The Office of the Chief Economist (OCE) has analyzed the daily position changes of all market participants reporting through our Large Trader Reporting System and how those position changes relate to price changes in the market. Importantly, our data cannot isolate index fund positions directly in the crude oil market, but rather can only use swap dealer positions as a proxy for index fund activity. In this regard, our assessment of hedge fund activity is much more robust than our assessment of index fund activity. The Commission's recent special call to swap dealers regarding index fund trading aims to generate more accurate data regarding index fund activity in crude oil markets. (By contrast, many agricultural futures markets have clean data on index fund activity allowing for an indirect assessment of index fund activity relating to price changes. In most of these agricultural markets, OCE analysis finds that index fund position changes do not significantly lead price changes, but rather, generally follow price changes as my testimony notes.)

To date in the crude oil market, OCE has not found that the position changes by swap dealers or hedge funds (or the combination of the two) lead price changes in any consistent manner. The telltale signs of a price floor would be evident with a particular group of trader buying in a manner consistent with maintaining existing price levels. A price floor may entail buying activity following price increases coupled with an increase in buying activity preventing, or limiting, downward price movements. In this regard, we have found no consistent evidence of funds establishing price floors. Our analysis shows that swap dealers and hedge funds are largely price followers, which entails buying on the day following price increases and (most inconsistent with a price floor) *selling on the day following price declines*. This analysis examines all trading days, including both positive and negative return days together.

Since the hearing, OCE has also examined negative return days in isolation, finding no significant pattern of swap dealers or hedge funds buying to establish a price floor, either on days that prices fall or on days following price drops. OCE continues efforts to isolate the index fund activity within crude oil markets, working on an intensive effort to build position data from the voluminous set of individual trades in this market. The mapping of trades to end of day position data is very labor intensive and time consuming. OCE believes, however, that our analysis to date provides substantial evidence that funds are not trading in a manner that establishes a price floor.

3. Some market participants are interested in repealing restrictive CFTC regulations on agricultural options and liberalizing the trading of swaps on agricultural commodities. How much of these changes can the Commission accomplish itself? How much require legislation from Congress?

At this time, it does not appear that new legislation would be needed to accomplish either objective. Agricultural trade options, and swap agreements, are both addressed in existing Commission regulations. *See* 17 C.F.R. §§ 32.13, 35.1, and 35.2. These regulations may be repealed or modified by the Commission (subject to the requirements of the Administrative Procedure Act). In fact, the Commission announced that it is reviewing both issues under its existing authority as part of its agricultural initiatives announced April 22nd.

4. Mr. Harris—You have undoubtedly heard of Tyson Slocum, Director of Public Citizen's Energy Program and his claim that $30 of the current price of a barrel of oil is due purely to speculation. Have you reviewed his economic methodology for arriving at that number? Is he right? Is he wrong? What about the claim of Mr. Stephen Simon, a member of Exxon-Mobil's board of directors, that price of a barrel of oil should be $50-55?

OCE has contacted Mr. Slocum and found that his testimony was based on a 2006 report by the Senate Permanent Subcommittee on Investigations titled, "The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat" and not on his own independent economic analysis. Mr. Slocum's organization used the estimate given in the report

(at 2006 oil prices) and extrapolated the numbers to arrive at an estimate of $30 at current oil prices.

OCE notes that similar claims have been made for the past few years as crude oil prices have climbed steadily. Given the dearth of evidence that speculator position changes are systematically leading price changes, it appears that the market has been more often correct than market prognosticators. However, we remain vigilant in analyzing data and recognize the potential for prices to overshoot what might be supported by supply and demand fundamentals.

We continue to follow up on statements made by other market prognosticators to examine the economic rationale that underlies these statements. To date, we have not received replies from any of them that explain or detail any economic source or analysis backing their statements.

5. Last year, the Commission made changes to its Commitment of Traders Report by reporting separately the aggregate positions held by long-only, passively managed investment funds with regard to agricultural commodities. Are plans in place to expand this to include energy commodities? If so, when will they be applied? If not, why not?

In 2006, when the Commission determined to publish a Commitments of Traders (COT) Supplemental Report reflecting the aggregate futures and option positions of non-commercial, commercial, and index traders in various agricultural commodities, it also closely studied whether it would be feasible to publish similar data for energy and metals markets. At that time, the Commission found that there would be significant problems accurately classifying commodity index trading activity in energy and metals futures markets and concluded that a similar supplemental report for such trading would be potentially misleading and therefore would not enhance market transparency.

The Commission's conclusion was based on an evaluation of the large-trader data available to the Commission, and in particular on an assessment of the accuracy with which that data could be parsed out, for firms engaged in commodity index trading, between such index trading and other unrelated trading activity. In the case of energy and metals markets, there are alternative U.S. and non-U.S. exchanges, as well as a multitude of over-the-counter (OTC) markets and derivatives products. Many swap dealers, for instance, in addition to their commodity index-related OTC activity, enter into other OTC derivatives transactions in individual commodities, both with commercial firms hedging price risk and with speculators taking on price risk. In addition, some swap dealers are very actively engaged in commercial activity in the underlying cash market, such as physical merchandising or dealing activity. As a result of these other activities, the overall futures positions held by these energy and metals traders in CFTC-regulated markets do not necessarily correspond closely with their hedging of OTC commodity index transactions. Indeed, placing the futures positions of such swap dealers in an index trader category in a supplemental report would not accurately reflect commodity index trading activity for energy and metals markets.

Notably, the Commission is continuing to evaluate steps that it can take to improve transparency

for energy market index trading activity. The Commission announced on May 29th that it would be using its existing special call authorities to immediately begin to require traders in the energy markets to provide the agency with monthly reports of their index trading to help the Commission further identify the amount and impact of this type of trading in the markets. Based upon this information, the Commission plans to develop a proposal to routinely require more detailed information from index traders and swap dealers in the futures markets, and to review whether classification of these types of traders can be improved.

6. In his testimony, Mr. Duffy with the CME called on the CFTC to lift the prohibition on clearing of agricultural swap products traded in over-the-counter markets (OTC). Where is the Commission regarding this proposal?

The Commission recently announced that it has tasked its staff to develop a proposal for allowing the clearing of agricultural swaps. The Commission noted in its announcement that this initiative will "provide farmers and grain merchandisers with another choice for managing price and basis risk with the benefit of centralized clearing and the regulatory transparency that accompanies clearing."

7. In his testimony, Mr. Stallman with the American Farm Bureau asked the CFTC to analyze the possible effects on market participants of lowering daily trading limits and to consider requiring additional delivery points to prevent potential market manipulation. Can you comment on these proposals?

Price Limits

Futures exchanges adopt price limits to perform three functions: (1) to reduce or constrain price movements in a trading day that may not be reflective of true market conditions but might be caused by traders overreacting to news; (2) to allow additional time for the collection of margins in times of large price movements; and (3) to provide a "cooling-off" period for futures market participants to respond to bona fide changes in market supply and demand fundamentals that would lead to large cash and futures price changes.

While price limits have the noted benefits, such limits can have disadvantages. If set too narrowly, price limits can inhibit the ability of futures prices to reflect changes in cash market conditions which may adversely affect trading in the futures contract and undermine the hedging and pricing uses of the futures market. Price limits may impede the ability of futures markets to discover prices in times of significant market movements and can exacerbate price uncertainty and lead to increased price volatility. Daily price limits also may adversely affect a market's risk management, since commercial users are prevented from liquidating existing hedge positions and cannot establish new hedge positions when trading is halted as a result of market prices reaching the daily price limits.

Accordingly, the Commission has generally not required price limits on futures contracts, and stated that if an exchange does adopt price limit provisions, then such daily price limits should

be set at levels that are not overly restrictive in relation to price movements in the cash market for the commodity underlying the futures contract. Price limit provisions adopted by an exchange are subject to review by the Commission to ensure that they meet this standard.

Delivery Points

The Commission has long held that the terms and conditions of a futures contract that provides for physical delivery should, to the greatest extent possible, reflect the usual practices and conditions in the cash market for the commodity underlying the futures contract. In particular, the terms and conditions should be designed to avoid any impediments to the delivery of the commodity to ensure that the price of the futures contract converges to the cash market value of the commodity at the expiration of a trading month.

A futures contract may provide for future delivery at a single location or at multiple locations where the underlying cash commodity is normally transacted or stored and where there exists a viable cash market(s). When specifying delivery points, an exchange should make certain that the "deliverable supply" of the commodity at the specified location or locations is sufficient to ensure that the contract would not be conducive to price manipulation or distortion. In general, the term "deliverable supply" means the quantity of the commodity meeting contract specifications that can be expected to be readily available to short traders and salable by long traders at its market value in normal cash marketing channels at the contract's delivery points during the specified delivery period.

The advantage of a single delivery point is that it provides pricing certainty to the buyer and seller, and makes it more likely that a hedger will enjoy a stable relationship between its own prices and those of the futures, i.e., a stable basis. Multiple delivery points introduce uncertainty as to the pricing point, and this can increase basis risk for potential hedgers. This basis risk can be diminished, however, through the proper specification of differentials that reflect normal price differences between delivery locations.

There has been much concern about an apparent lack of convergence of cash and futures markets for some agricultural commodities, particularly with respect to the grain markets. We understand that the Chicago Board of Trade is working with producers, merchandisers, processors and other industry groups to identify the underlying causes of the problem and to recommend solutions, including potential changes to the delivery specifications of the futures contracts. The Commission is being kept apprised of these deliberations, and is prepared to take any appropriate action to effect a solution.

8. As you know, there are some proposals seeking to give the CFTC authority and directive to collect trading information on energy-based derivatives from the OTC market on a regular basis. The farm bill's CFTC reforms allow this for derivatives traded on an exempt commercial market if the derivative serves a significant price discovery function. But others want you to get at the voice-brokered bilateral contracts as well.

Assuming such a proposal took place, how much information would be coming to the CFTC; does your agency have adequate staff levels to sort through this data; and how helpful would this information be in the agency's efforts to detect manipulation, given the nature of derivatives traded in the OTC market?

It is difficult to know the magnitude of the information to be collected, as we do not know the size of the bilateral OTC market, the number of transactions or the universe of actual and potential traders. Moreover, it is not clear how the data would be assembled and then incorporated into our large trader system, given that we do not know the identities of all the participants and the OTC trades are not necessarily standardized and may not be cleared. With no centralized party (such as a clearing organization) collecting the necessary information, extraordinary human and IT resources would be required to monitor and enforce such a requirement. Also, the information may not be particularly useful for surveillance in detecting manipulation, given that the transactions likely have a variety of different, specifically tailored terms.

9. **Some question CFTC's issuing of no action letters for foreign boards of trade which trade energy commodity contracts delivered in the United States. They challenge the CFTC's assertion that foreign regulators, the Financial Services Authority (FSA) in London for example, have comparable oversight of their markets as does the CFTC. How is comparable oversight determined by the CFTC? Is this done on a contract by contract basis or is the determination made by looking at the regulator holistically?**

In the review to determine the comparability of regulatory oversight, Commission staff looks to the regulator's responsibilities generally and to the responsibilities it levies on the foreign boards of trade that it oversees to determine: (1) if its regulatory objectives are substantially similar to those of the Commission and (2) how those regulatory objectives are expected to be met. Staff reviews the statutory or regulatory requirements for which the regulator is responsible, *i.e.*, does the authorizing statute require that the regulator assure that the market be fair and orderly or not susceptible to manipulation? Staff then looks to the rules and procedures of the regulator to see how the regulator expects to meet the requirement. If the regulator mandates that the foreign board of trade must be the first step in meeting the requirement, staff analyzes the foreign board of trade's rules to ensure the requirement is mandated by rule and then looks to the compliance, enforcement and disciplinary mechanisms of the foreign board of trade to determine if it appears that the requirement can be adequately met. The review is not on a contract-by-contract basis because the staff expects that the regulatory requirements should apply equally to all contracts that U.S. citizens can trade under the no-action letter.

Essentially, the staff review seeks to determine that the foreign board of trade is subject to governmental authorization, appropriate rules prohibiting abusive trading practices, and continuing oversight by a regulator that has powers to intervene in the market and share information with the Commission. The staff's review generally reflects the internationally accepted approaches used by many developed market jurisdictions to govern access to foreign

electronic exchanges. These approaches generally are based upon a review of, and ongoing reliance upon, the foreign market's "home" regulatory regime, and are designed to maintain regulatory protections while avoiding the imposition of duplicative regulation.

10. What information does the Commission receive from the FSA with regard to lookalike contracts traded on FSA-regulated exchanges that mirror contracts traded on CFTC-regulated exchanges?

Since 2006, the FSA has routinely provided the Commission weekly trader information for nearby futures contracts, and provided daily trader information in the final trading week of each futures expiration, to facilitate rigorous oversight of the linked WTI Crude Oil contracts traded on both NYMEX and ICE Futures Europe. While this information sharing has been effective, the Commission recognized that there were several areas in which the regulatory oversight of these markets could be enhanced. Accordingly, for purposes of vigilant market oversight, on May 29th the Commission announced several initiatives to bring more transparency to the energy markets.

More specifically, with respect to the WTI crude oil futures contract, the FSA and ICE Futures Europe have agreed to the following enhanced information sharing measures:

1. Immediately implementing expanded information-sharing to provide the Commission with daily large trader positions in the ICE Futures Europe WTI crude oil contract;

2. Extending trader information sharing to provide crude oil large trader position data for all contract months in the ICE Futures Europe WTI contract, not just the nearby months;

3. A near-term commitment to enhance trader information to permit more detailed identification of market end users;

4. A near-term commitment to provide improved data formatting so trading information can be seamlessly integrated into the Commission's surveillance system; and

5. In addition to the established position management program that FSA currently requires of ICE Futures Europe, ICE Futures Europe will notify the Commission when traders exceed position accountability levels, as established by U.S. exchanges, for WTI crude oil contracts.

These recently-announced modifications will expand information sharing between the Commission and the FSA, and will enhance their oversight of their respective crude oil markets. We are committed to fully implementing all these initiatives in an expedited fashion. In addition, we continue to work with the FSA and ICE Futures Europe to identify any further improvements to our international regulatory scheme and will notify you of any further developments.

11. In his testimony, Mr. Weill with the American Cotton Shippers Association recommends that the CFTC require the reporting of all swap and OTC contracts by market participants in order to determine the aggregation of positions from all sources. He also recommends the CFTC use emergency authority to require ICE

and its clearing members to adhere to practice of margining futures to futures settlements and options to option settlements as opposed to establishing futures margins at the synthetic level determined by the close of the options contract. Can you comment on any of these proposals? Are they being reviewed by the Commission?

The Commission has been responsive to Mr. Weill's concerns and will continue to review the issues he has raised. The Commission has recognized the need to improve its access to information about OTC positions held by large traders in Commission-regulated markets and in October 2007 the Commission amended Regulation 18.05 to clarify that traders holding reportable positions are required to keep information relating to those positions – including information regarding positions and transactions held or executed outside the regulated market – and to provide that information to the Commission upon request. While this rule change does not require reporting of all the information recommended by Mr. Weill, it does assure that critical information is available if needed.

On June 3rd the Commission announced a series of initiatives in the agricultural area, some of which are focused on improving transparency in the trading of agricultural futures. With respect to cotton in particular, as a part of its announcement on June 3rd, the Commission took the extraordinary step of disclosing that it had opened an enforcement investigation into events in the cotton market. We regard to Mr. Weill's specific concern about margin requirements, the agency is well aware of the extraordinary financial demands placed on the holders of short positions in cotton futures and is sympathetic to their situation. The Commission has involved representatives from the Farm Credit Administration, the Chicago Federal Reserve Bank, and the Kansas City Federal Reserve Bank in its review of this issue. Also, it is one of the issues that the Commission's Agricultural Advisory Committee has been asked to examine. The American Cotton Shippers Association is represented on this advisory committee, so Mr. Weill's concerns will receive additional attention in that forum as well.

Currently, futures prices are subject to price limits, and options prices are not. ICE Futures U.S. (formerly NYBOT) has required that margining for futures and options settlements be done using synthetic options prices when the futures market is locked to the limit. On June 12, 2008, ICE Futures U.S. requested Commission approval of proposed amendments establishing price limits for options contracts at the same level as those for futures contracts. In support of the amendments, ICE Futures U.S. states, "Having such limits applicable to options contracts eliminates the mandatory obligation of using synthetics when determining margin for futures and options contracts that are subject to price limits." These proposed amendments are under review by Commission staff.

12. **In his testimony, Mr. Neimeyer with the National Corn Growers states that the CFTC should impose a moratorium on further hedger determinations to prevent other non-traditional traders from receiving that designation and the limits that go with it until the Commission conducts further review on it makes such determinations. Can you comment on that proposal?**

Yes, the Commission is aware of concerns by Mr. Neimeyer and others about the large positions of non-traditional hedgers in some agricultural markets. As part of its June 3rd announcement of agricultural initiatives, the Commission announced that it had voted to withdraw proposed rulemakings that would have increased the Federal speculative position limits on certain agricultural futures contracts and created a risk management hedge exemption from the Federal speculative position limits for agricultural futures and option contracts. In making this announcement the Commission said that, "[a]s part of [its] data gathering and policy review, the Commission will be examining the policy of CFTC staff granting exemptive relief from the CFTC's Federal speculative position limits relating to agricultural commodity index trading. During this review period, the Commission will be cautious and guarded before granting additional exemptions in this area."

Questions from Full Committee Ranking Member Bob Goodlatte

1. Are commodity index funds, sovereign wealth funds and other managed funds treated as speculators or hedgers?

These classes of traders are generally seeking market exposure to commodities as an asset class; as such, they are not considered bona fide hedgers. Hedgers, by definition, are trying to cover or reduce an existing market exposure. Thus, if a swap dealer sold swaps to a pension fund based on a commodity index and then the swap dealer itself established an offsetting position in futures contracts, the swap dealer would be considered a hedger.

2. If they are treated as hedgers, what are they hedging?

As noted above, they are not treated as hedgers. The swap dealer in the above answer would be treated as a hedger because it is using the futures markets to reduce the commodity price risk that it is exposed to as part of its commercial activities of offering risk management products to its clients.

Questions from Congresswoman Stephanie Herseth Sandlin

1 Grain elevators and farmers have not been able to use markets as they have historically done as a vehicle for price discovery and risk management. I've heard from producers in South Dakota that they no longer trust the CBOT to fulfill its traditional role. What can the CFTC do to try to address this situation?

The Commission recognizes the tremendous challenges faced by farmers and grain elevators in the current market environment. Among other things, farmers and elevators have experienced difficulties in conducting traditional risk management operations on futures exchanges, such as the Chicago Board of Trade, due to problems such as a lack of convergence between cash and

futures prices, which can undermine the effectiveness of traditional hedging strategies. Another problem centers on increased margin exposure by grain elevators in a rising market, which can cause elevators to limit the hedging / forward contracting opportunities they are able to offer to farmers.

On April 22, 2008, the Commission hosted an Agricultural Roundtable designed to bring together all the different views and voices from around the marketplace to review and seek solutions to current problems in the agricultural markets. One panel specifically addressed "Hedging in the Agricultural Futures Markets," including convergence of futures and cash prices and forward contracting in the current markets. Another panel covered "Margin Levels and Agricultural Credit."

On June 3, 2008, the Commission announced a series of initiatives designed to follow up on the concerns raised at the April 22 Roundtable. The actions announced included promoting "Greater Risk Management Choices for Farmers and Agribusiness," through: (1) a review aimed at improving the effectiveness of the Commission's agricultural trade options program, which may provide producers with an alternative for hedging price risk, with the added benefit of a fixed premium (limiting potential losses to the amount of the premium without restricting upside profit potential); and (2) an initiative to develop a proposal to allow for the clearing of agricultural swaps, which would provide farmers and grain merchandisers with "another choice for managing price and basis risk with the benefit of centralized clearing and the regulatory transparency that accompanies clearing."

With respect to margins and agricultural lending, the Commission announced that:

> CFTC staff is coordinating with agricultural banking authorities, including the Federal Reserve Banks of Chicago and Kansas City as well as the Farm Credit Administration, regarding financing and credit issues arising from higher margins in the futures markets. As prices of all commodities rise, financing of margin levels becomes more difficult for commodity merchandisers and producers. The CFTC is working with agricultural lenders to facilitate an understanding of financing issues faced by market participants.

In addition, the Commission has asked its Agricultural Advisory Committee, an advisory body that includes representatives from the major agricultural / agribusiness producer and trade groups, as well as agricultural lenders, to address the following issues in the coming months:

- Develop solutions for improving convergence in the futures and cash markets;
- Discuss practices of exchanges on determining margin, daily price limits and methodologies of setting settlement prices;
- Facilitate discussion on the role and size of OTC agricultural swaps; and
- Determine whether there are additional studies agricultural market users believe the Commission should undertake relevant to current agricultural commodity prices.

Finally, the Commission continues to work with the Chicago Board of Trade and other exchanges to address current problems in the agricultural markets. We understand that the CBOT is working with producers, merchandisers, processors and other industry groups to identify the underlying causes of the lack of convergence problem and to recommend potential solutions, including potential changes to futures contract delivery specifications. The Commission is being kept apprised of these deliberations and is prepared to take any appropriate action to effect a solution.

2 **While most grain producers will not object to the high prices of ag commodities, we do have to acknowledge the significant effect these prices are having on grain hedgers, and therefore our producers. The margins that used to be paid by grain elevators are so high that those costs have been passed onto farmers. Instead of allowing the grain elevators to hedge risk and pay margin calls, producers in many cases now have to come up with the margin cost themselves, which they have not had to do in the past.**

Particularly at this time of year then farmers have already spent money on fuel, feed, and fertilizer, the last thing they can afford is a high margin call. So, our producer will go to a bank or credit agency for a loan. However, loans are only being given out based on the cash prices of commodities. Since these cash prices are lower than the futures price, farmers frequently can't get enough credit to pay the margin calls, and therefore hedge risk.

This may be more of a credit issue, but I would be interested in hearing if there anything under your authority that you could do? Is there anything you can recommend?

As discussed in response to the foregoing question, Commission staff is coordinating with agricultural banking authorities, including the Federal Reserve Banks of Chicago and Kansas City as well as the Farm Credit Administration, regarding financing and credit issues arising from higher margins in the futures markets. As prices of all commodities rise, financing of margin levels becomes more difficult for commodity merchandisers and producers. The Commission is working with agricultural lenders to facilitate an understanding of financing issues faced by market participants.

In addition, the Commission has asked its Agricultural Advisory Committee to work on several issues worthy of further industry input and study in the coming months, including practices of exchanges on determining margin, daily price limits and methodologies of setting settlement prices.

Written Response to Mr. Neugebauer's questions to Mr. Thomas Farley for the Subcommittee on General Farm Commodities and Risk Management, Committee on Agriculture

Hearing Record, May 15, 2008

In further response to the questions posed by Mr. Neugebauer regarding the ICE Clear U.S. Cotton No. 2 price limits and the margin calls on March 3 and 4, 2008, the following information is respectfully submitted for the May 15, 2008 hearing record:

Price Limits: The Exchange has a long-standing rule that sets limits on the amount by which the price of futures contracts on Cotton No. 2 may increase or decrease during a single trading session from the previous day's settlement price. When the price of the futures contract is below 84 cents this price limit is 3 cents and when the futures contract price is above 84 cents, then the limit is 4 cents. There are no price limits on the options on the Cotton No. 2 futures contract. Thus, if the futures price hits the limit (also known as "going limit-up" or "limit-down"), the options can continue to trade, thereby continuing the price discovery function of the Exchange's market.

The price limits have been triggered 18 times in the first 60 trading days of 2008. One of the arguments for price limits is that they dampen volatility and give the market time to breathe, while keeping the options market open provides a vent for market participants who need to continue to move in and out of positions. Based on recent activity which does not on the surface seem to bear out the merits of this argument, the Exchange is taking another look at the price limit structure and hopes to dialog more fully with the Cotton Committee about this rule. The Committee is comprised of 20 cotton industry representatives.

Margin Requirements: Original margin, which is established by the Exchange and its Clearing House, is a good faith deposit to guarantee performance on open contracts. The Clearing House sets initial margin amounts for each contract such that 97% of all one-day moves are on deposit in advance. In order to calculate the statistically implied 97% move, the Clearing House uses historical and implied price volatility, current and expected market conditions and other relevant factors. Each trader carrying an open position must maintain original margin on deposit with the firm carrying the trader's account, in accordance with Exchange and CFTC rules. If the firm carrying the account is not a member of the Clearing House, it must establish an account with such a firm (a "Clearing Member") which, in turn, maintains original margin deposits on the aggregate open contracts it carries with the Clearing House.

Twice a day, the Clearing House determines a price to which all such open positions are marked, and collects variation margin from the Clearing Members carrying positions experiencing a net loss since the last settlement cycle, and pays variation margin to the Clearing Members carrying positions experiencing a net gain since the last settlement cycle. This mark-to-market system prohibits losses from accumulating or being deferred over time and enables the Clearing House to remove debt obligations among market participants as they arise during the day. Consequently, it is the cornerstone of the system of financial integrity that the Clearing House provides to the market and that has served these markets so well for 150 years.

It is important to note that our Exchange does not derive any material monetary benefit from the collection and payment of variation margin among its Clearing Members.

Determining the Price to Which Positions are Marked: Because there are price limits on cotton futures, but not on options, the options market may trade after the price limits on cotton futures have restricted further trading above/below the relevant limit price. A trader who buys a call option while simultaneously selling a put option at the same strike price has purchased the economic equivalent of a futures contract. Conversely, a trader who sells a call option while simultaneously buying a put option at the same strike price has sold the economic equivalent of a futures contract. As a result, the option market provides a means for price discovery to continue when the futures market price has reached the permitted limit. For this reason, options prices are considered to be a more accurate indicator of the real value of cotton futures when the futures market has reached its permitted limit.

Almost a decade ago the Exchange adopted a rule, with the approval of its Cotton Committee, to address the mark-to-market calculation when cotton trades at a limit price. The rule provides that the price to which open positions are marked will be derived from option transactions, rather than from the artificially limited price of the futures contract. Thus, in limit situations, the Clearing House calculates a settlement price using options trade data to ensure that it collects variation margin sufficient to cover the true risk of the positions it clears. As the financial counterparty to every cleared trade, the financial integrity of the Clearing House assures the financial integrity of the Exchange marketplace in cotton and every other Exchange contract cleared by the Clearing House.

Price Movements in Early 2008 and Resulting Margin Calls: The price of cotton in the cash market as well as the futures market had been generally increasing since early 2007. Notably, however, both spot prices (including East Texas & Oklahoma, North Delta, and SEAM) and Cotton No. 2 Futures rose quickly and significantly for 12 days, starting February 21, 2008. [See attached CFTC chart comparing various spot prices with May 08 Cotton No. 2 prices for that period.] Interestingly, those price increases started at about the same time that USDA held its Agricultural Outlook Forum (February 21-22, 2008), where projected forecasts for supply and demand for the 2008/09 cotton crop were issued. Compared to 2007/08, USDA forecasted a 12.3% decrease in planted acres, a 19.6% drop in total supply, and a 61.7% decrease in ending stocks. The stocks-to-use ratio was projected to drop to 19.1, compared to 50.5 for 2007/08.

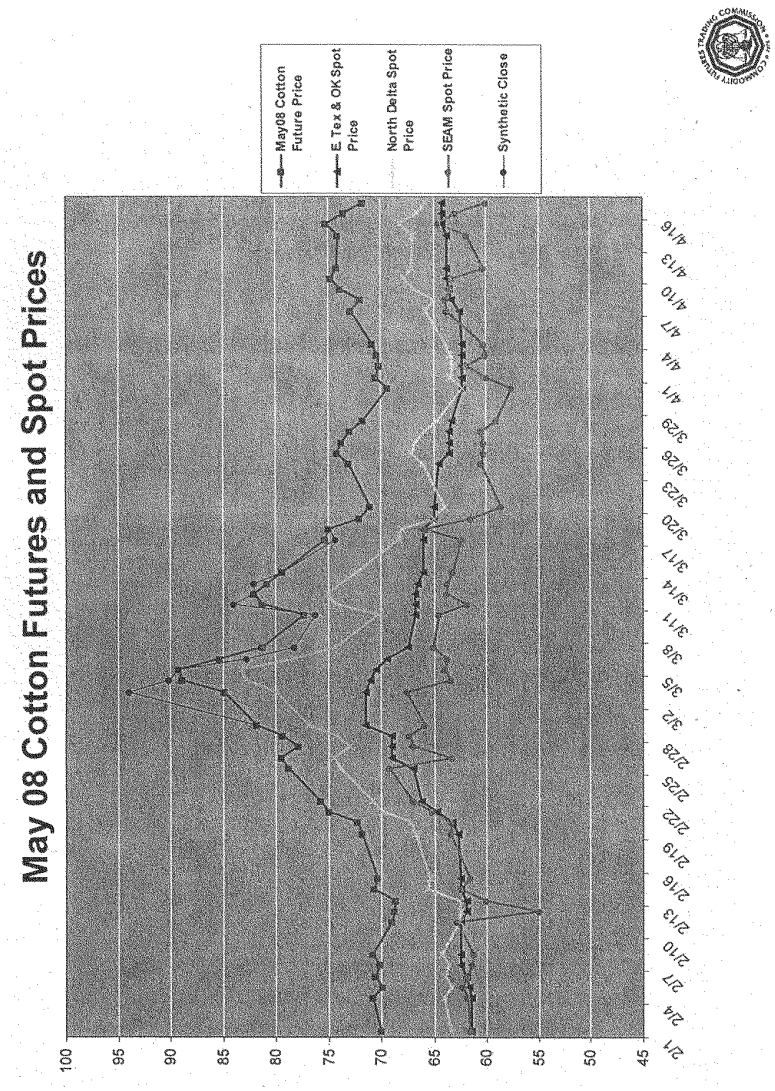
On March 3, the May 08 Cotton No. 2 futures traded at the limit-up price, reaching 85 cents. That same day, options on the May contract reached 94 cents. The Clearing House, following its long-standing rule, used prices from cotton options transactions to determine the settlement price that would be used for marking futures positions to the market. When Clearing Members issued variation margin calls to their customers, traders with net short positions, predominately cotton producers and merchants, were required to pay approximately $1 billion in cash, which was then paid by the Clearing House to meet its obligations to traders on the other side of the market that had accrued profits equal to that amount. Some of those producers and merchants were not able to readily find financing to cover such high margin calls. At the same time, they were unable to sell physical cotton to raise cash to meet the margin calls. These firms were therefore required by

their financing providers to liquidate a large portion of their short futures contracts on the next day, March 4th. Because of this widespread liquidity squeeze and related forced liquidation, March 4 was extremely volatile, with a trading range equal to 25 cents, or 30% of the price of cotton, including several large directional price swings.

If on those days the Clearing House had used the limit price in cotton futures to calculate variation margin, (a price that was materially lower than the price indicated by the trades in cotton options), it would have been tantamount to the Clearing House extending approximately $600 million of credit to the traders with losing positions without any additional collateral. Without a more prudent limit and margin structure in place, allowing such losses to accumulate in this fashion could jeopardize the financial integrity of the entire clearing system, resulting in the financial ruin of traders and Clearing Members, including those holding profitable positions in other futures and option contracts. In short, to do so would run contrary to the risk management practices and system of financial safeguards that is the hallmark of the futures industry.

Since March 4, we have worked with the industry and made a few alterations to our margining procedure. Twice since this time we have used the limit-up price to calculate variation margin for futures when the market has traded past the limit-up price. This is a difficult issue on which the Exchange and the industry must continue to work together to find common ground. From the Exchange's perspective, we must protect the integrity of the Clearing House. From the industry's perspective, we must have a methodology that enables them to finance margin requirements when there is a significant one- or two-day price move. Despite the rancor, our interests are aligned on this issue. The Exchange benefits when our customers have capital to trade; it does not make a penny on margins. And, our customers certainly do not want to put the Clearing House at risk. Therefore, we are optimistic that we will find common ground.

Attachment: CFTC Cotton Spot and Futures Price Comparison Chart


May 08 Cotton Futures and Spot Prices
May08 Cotton Future Price
E. Tex & OK Spot Price
North Delta Spot Price
SEAM Spot Price
Synthetic Close
100
95
90
85
80
75
70
65
60
55
50
45
2/1
2/4
2/7
2/10
2/13
2/16
2/19
2/22
2/25
2/28
3/2
3/5
3/8
3/11
3/14
3/17
3/20
3/23
3/26
3/29
4/1
4/4
4/7
4/10
4/13
4/16

○