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# HEARING TO REVIEW LEGISLATION AMENDING THE COMMODITY EXCHANGE ACT

## HEARINGS

BEFORE THE

## COMMITTEE ON AGRICULTURE
## HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

JULY 9, 10, 11, 2008

**Serial No. 110–40**

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# HEARING TO REVIEW LEGISLATION AMENDING THE COMMODITY EXCHANGE ACT

**WEDNESDAY, JULY 9, 2008**

HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
*Washington, D.C.*

The Committee met, pursuant to call, at 2:39 p.m., in Room 1300 of the Longworth House Office Building, Hon. Collin C. Peterson [Chairman of the Committee] presiding.

Members present: Representatives Peterson, Holden, McIntyre, Etheridge, Baca, Cardoza, Marshall, Herseth Sandlin, Cuellar, Costa, Salazar, Ellsworth, Boyda, Space, Kagen, Pomeroy, Barrow, Donnelly, Childers, Goodlatte, Lucas, Moran, Hayes, King, Neugebauer, Boustany, Conaway, Fortenberry, Schmidt, Smith, and Latta.

Staff present: Adam Durand, Alejandra Gonzalez-Arias, Scott Kuschmider, Clark Ogilvie, John Riley, Kristin Sosanie, Bryan Dierlam, Alise Kowalski, Kevin Kramp, and Jamie Weyer.

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

The CHAIRMAN. The Committee will come to order. First of all I want to welcome everybody to today's hearing. It is the first of three scheduled hearings that this Committee is going to hold this week on legislation that would amend the Commodity Exchange Act, and I want to make a couple of announcements.

First of all, we are going to meet on Friday even though whether we are in session or not, and I don't know if that decision has been made, but even if we are not in session, we will meet. We need to get this work done, and initially we had talked about 10 o'clock, but my intention is to move that meeting to 9 o'clock on Friday morning. So we will see how long it takes, so maybe we might be out of here by noon or something. So that is kind of the schedule. Tomorrow we will meet at 10 o'clock.

I want to begin by welcoming our six Members that are with us here today. We appreciate them being with us to discuss their legislative proposals that they have introduced that would affect the regulation of futures and the options markets. And they have agreed to be with us and not only present their bills but also to remain—to enter into a dialogue and question and answer session regarding their bills, as part of the process, to try to educate everybody about where everybody is coming from. So we appreciate that.

There is some discussion that there might be votes about 3 o'clock. I don't know if that is true or not, but we will have to work around that as best we can.

So as I said, tomorrow we are going to, well, one other thing I should say. We are going to do things a little bit different today. We are going to give the Members that are here 5 minutes to explain their proposals, but when we get to question and answers, we are not going to operate under a 5 minute rule like we have other times. What we are going to try to do is go around and recognize Members that will open lines of questioning in specific areas, and then we are going to kind of stay on that area to answer the questions, to try to keep this more focused on the different specific areas. Because people get confused about all the different areas. I still get confused about it, so we are going to kind of try to keep that focus. Bob and I have talked about this. We are not sure if it will work, but we are going to try it. If it gets out of control, we will probably have to go back to the 5 minute rule, try to get it back under control again. So we will see how that works.

Tomorrow we are going to have a wide variety of stakeholder groups, including exchanges, traders, hedgers, commodity producers, buyers, academic researchers, and more, and we are going to examine these bills that have been placed before us from all sides, and we are going to get all points of view.

While many factors are putting pressure on the price of oil, a growing number of people are coming to the conclusion that a flood of speculative money into energy futures is behind the crude oil record high prices. Two weeks ago over 400 Members of the House voted for legislation requiring that the CFTC utilize all of its authority to curb oil market speculation if it exists.

As oil continues to climb, several bills have been introduced that would affect the regulation of the futures market that trade crude oil and other energy contracts. Speculation has been the boogey man for commodity markets since their inception. Whenever someone did not like the way the commodity prices were going, whether it was up or down, they would raise the specter of the dreaded speculator.

Personally, I have yet to see very much hard data proving that increased speculation is responsible for the record increase in commodity prices that we have seen and have been experiencing. However, I am willing to examine this and be convinced.

Given that charges against speculators have historically been more wrong than right, it is important that we have the facts, the data, the analysis that demonstrate the validity of this contention before we take action.

Any legislative remedy that seeks to remove speculative interests from futures markets could result in more volatile markets, as the role of speculators has always been a vital price discovery and liquidity option. But as CFTC Commissioner Bart Chilton recently said, "There are dollars that did not exist in these markets a few years ago," entering the markets. And the CFTC has testified on multiple occasions that their information on those trading in crude oil futures is incomplete. That is why it is important for this Committee to be thorough in examining these proposals in order to make the best-informed decisions possible.

Some changes being proposed for energy future contracts may be good for those contracts but may have a negative effect on other sectors, including agriculture, and that is one of the big concerns of this Committee.

Increasing margin requirements, for example, would be very problematic, as volatility in the futures prices of the grains that form the backbone of our food supply system has already made it tough for elevators in farm country to meet the margin calls. And we have had numerous calls from people around the country regarding that.

We have seen and heard examples on this Committee of elevators having to double or triple their credit lines just to be able to afford the forward-pricing contracts to farmers. And such instability can have serious effects on the prices that we pay in the supermarket.

I just left a meeting with some of my farmers where they were imparting me, and this isn't the first group, that they were unable to secure forward pricing for their crops because of the existing margin situation. And so if we make it worse, it is going to be an even bigger problem.

The House Agriculture Committee has a proud tradition of bipartisan support. These hearings have not been scheduled so that we can gain answers and seek solutions and not engage in the same old partisan gas-price politics that we have seen sometimes in the past.

As the Committee with jurisdiction over futures and option markets, we will be thoughtful and deliberate in examining all of these legislative proposals in order to develop a bipartisan, consensus bill that we can move to the House floor before the August recess. Since we are already in the second week of July, this means that time is short, and the Committee has a lot of work to do.

With that said, I again welcome our colleagues on today's panel, and I would now yield to my friend and Ranking Member of the Committee, Mr. Goodlatte, for an opening statement.

[The prepared statement of Mr. Peterson follows:]

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

I want to welcome everyone to today's hearing.

Today is the first of three scheduled hearings this Committee will hold this week on legislation that would amend the Commodity Exchange Act.

I want to begin by welcoming six of our House colleagues to today's panel who are here to discuss legislative proposals they have introduced that would affect the regulation of futures and options markets.

Tomorrow, we will discuss these and other legislative proposals with a wide variety of stakeholder groups, including exchanges, traders, hedgers, commodity producers and buyers, academic researchers, and more. We will examine these bills from all sides, and will get all points of view.

While many factors are putting pressure on the price of oil, a growing number of people are coming to the conclusion that a flood of speculative money into energy futures is behind crude oil's record high prices. Two weeks ago, over 400 Members of the House voted for legislation requiring the Commodity Futures Trading Commission to utilize all its authority to curb oil market speculation.

As oil continues to climb, several bills have been introduced that would affect the regulation of the futures markets that trade crude oil and other energy contracts.

Speculation has been the boogey man for commodity markets since their inception. Whenever someone did not like the way commodity prices were going, whether it was up or down, they would raise the specter of the dreaded speculator. Person-

ally, I have yet to see any hard data proving that increased speculation is responsible for the record increases in commodity prices we have been experiencing. Given that charges against speculators have historically been more wrong than right, it is important that we have the facts, data, and analysis that demonstrate the validity of this contention before we take action.

Any legislative remedy that seeks to remove speculative interests from futures markets could result in more volatile markets, as the role of speculators has always been vital for price discovery and liquidity. But as CFTC Commissioner Bart Chilton recently said, "there are dollars that did not exist in these markets a few years ago." And CFTC has testified on multiple occasions that their information on those trading in crude oil futures is incomplete. That is why it is important for this Committee to be thorough in examining these proposals in order to make the best-informed decisions possible.

Some changes being proposed for energy futures contracts may be good for those contracts but may have a negative effect for other sectors, including agriculture.

Increasing margin requirements, for example, would be very problematic, as volatility in the futures prices of the grains that form the backbone of our food supply has already made it tough for elevators in farm country to meet margin calls. We have seen and heard examples on this Committee of elevators having to double and triple their credit lines just to be able to offer forward-pricing contracts to farmers. Such instability can have serious effects on the prices we pay at the supermarket.

The House Agriculture Committee has a proud tradition of bipartisan cooperation. These hearings have not been scheduled so that we can gain answers and seek solutions and not engage in the same old partisan gas-price politics.

As the Committee with jurisdiction over futures and options markets, we will be thoughtful and deliberate in examining all of these legislative proposals in order to develop a bipartisan, consensus bill that can move to the House floor before the August recess. Since we are already into the second week of July, that means time is short and this Committee has a lot of work to do.

With that said, I welcome our colleagues on today's panel and I now yield to my friend and Ranking Member of the Committee, Mr. Goodlatte for an opening statement.

## OPENING STATEMENT OF HON. BOB GOODLATTE, A REPRESENTATIVE IN CONGRESS FROM VIRGINIA

Mr. GOODLATTE. Well, thank you, Mr. Chairman, and thank you for calling today's hearing, a continuation of a series of hearings to review the role of the CFTC in the futures market. I welcome all of my colleagues who will be testifying here today.

I think that everyone here today would agree that America is in the midst of an energy crisis, and Americans everywhere are feeling the effects of high energy prices. It is important to look at all of the factors that would contribute to high energy prices, including supply and demand, global market conditions, weather, and production conditions as we try to develop a feasible solution to this problem.

However, one thing is clear. We need to increase domestic energy production in this country. We need to be more self-reliant, and we can't do that if we continue to rely on foreign energy sources. We must diversify our energy supplies by accessing our domestic sources of oil in Alaska, the Rockies, and offshore, continuing the development of alternative fuels, clean coal technologies, and encouraging the production of more nuclear sites which provide $CO_2$ emission-free energy.

While this Committee will look at all of the possible contributing factors under its jurisdiction that might be influencing higher energy prices, we have no reason to believe that there has been any nefarious activity in the futures market or on the part of speculators.

Furthermore, as we heard from the CFTC's acting Director, Walt Lukken, 2 weeks ago. The Congress has provided the CFTC with all of the tools and regulatory authority it needs to operate. Of particular interest and as noted by the Speaker of the House, the recently-enacted farm bill reauthorization closed the so-called Enron Loophole. In fact, the CFTC announced recently—recently unveiled several initiatives utilizing their existing authority that will allow them to gather data from areas of the market that we previously had very little information about. These new efforts will bring greater transparency to the markets which benefit everyone.

Americans are tired of paying big bucks for the energy they need to make it through the day, and frankly, I don't blame them. It can be easy to point fingers, but this is a complex and dynamic problem, and I urge caution in blaming only speculators. Speculators add liquidity to the markets and play a critical role in the market system that benefits traditional users of the market. Imposing artificial limits on speculation could cause speculators to dump their positions and create unintended consequences that would be devastating to everyone.

We will hear from a diverse array of witnesses this week, and I appreciate them lending us their expertise. I am concerned, however, that these hearings won't do anything to address high energy prices, and that American consumers will continue to feel the impact of high prices at the pumps, in heating and cooling their homes, and higher costs to feed their families. We are living the consequences of Congressional inaction in creating productive and sustainable domestic energy policy, and it is imperative that the Congress acts now instead of punting this problem further down the road.

Thank you, Mr. Chairman. I look forward to the testimony of our witnesses.

The CHAIRMAN. Thank you, Bob, and I want to recognize Bob Etheridge as well. Bob is Chairman of the Subcommittee that has jurisdiction in this area, and he and the Ranking Member, Mr. Moran, have done yeoman's work in this regard and provided tremendous leadership along with all the Members of that Subcommittee. So I want to recognize them for the great work that they have done with the number of hearings that they have held over the last little while, and Mr. Etheridge has a bill as well.

I would ask that all other Members submit their statements for the record.

[The prepared statements of Messers. Baca, Smith and Childers follow:]

PREPARED STATEMENT OF HON. JOE BACA, A REPRESENTATIVE IN CONGRESS FROM CALIFORNIA

Chairman Peterson and Ranking Member Goodlatte:

I am pleased to be here today to hear from different Members of Congress, their various proposals for limiting speculation and manipulation in the commodity futures market.

I thank the Chairman and Ranking Member for convening this hearing.

I also want to thank our witnesses for taking time from their busy schedule to be here today—and for their proactive involvement in working to find solutions to high gas prices.

In my home State of California—the average for a gallon of gasoline is now over $4.57. I repeat—the average price for a gallon of gasoline is $4.57!

With gas prices at this level, too many of our families have been forced to sacrifice. Simple actions like driving the kids to school, or making the extra trip to the market—all have become financial burdens for too many Americans.

It is important that we take a close examination of the commodity futures market—and especially the buying and trading of crude oil.

Mr. Chairman, I think everyone in this room realizes the urgent need for real relief at the pump. American consumers are tired of paying high gas prices!

While we will examine the merits of each initiative on their own, it is critical we continue to work together.

We must create a long-term energy plan that is both environmentally-friendly and domestically based; and also look at bold, short range solutions in order to help the American people who are suffering at the pump—like selling off a portion of our nation's *Strategic Petroleum Reserve*.

I look forward to hearing from our witnesses today and thank the Chairman and Ranking Member again for their leadership.

Thank you.

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PREPARED STATEMENT OF HON. ADRIAN SMITH, A REPRESENTATIVE IN CONGRESS FROM NEBRASKA

Good afternoon and thank you, Mr. Chairman.

The Third District of Nebraska, which I have the privilege to represent, is a primarily rural district. High gas prices disproportionately affect those in rural areas. My constituents drive long distances to town or between towns as part of their day-to-day routine. Agriculture is one of the primary industries in my district. Increasing input costs for crop production and escalating feed costs for livestock have many producers worried. In short, the increasing costs of food, feed, and energy have greatly impacted my constituents.

Historically, futures markets have played a key role in risk management for producers and consumers of a product, and for price discovery by the market. Speculators play an important role in the market by accepting the risk that producers and consumers hedge. The Commodity Futures Trading Commission has been granted the authority and given the charge by this body to oversee and regulate these markets to ensure transparency and prevent manipulation.

As we examine the recent, and sometimes rapid, increases in commodity prices, we must be careful not to hastily assign blame to a convenient scapegoat. Certainly, we do not want the marketplace to be manipulated by speculators, but we must take care it is not manipulated by government regulation either. I hope these hearings over the next few days will allow us to objectively examine the evidence and that we will thoughtfully consider legislation which will ensure the markets remain transparent and open while letting the markets work as they were intended. Ultimately, the government should allow market signals to work to increase supplies without over-regulation.

I appreciate the Committee holding these timely hearings. Mr. Chairman, I look forward to continuing to work with you, and I thank you for your time.

---

PREPARED STATEMENT OF HON. TRAVIS W. CHILDERS, A REPRESENTATIVE IN CONGRESS FROM MISSISSIPPI

I am here today to better understand the cause of the exorbitant energy costs that Americans are now facing. I want to thank Chairman Peterson and the other Members of this Committee for holding this essential hearing.

When I was elected, the price of gasoline was $3.61 per gallon. Barely, a month later the price of gasoline per gallon has jumped to over $4.00. Recently, I met with sweet potato farmers from my district who are facing increased production costs as the prices of diesel fuel, fertilizer, and gasoline all rise.

These price spikes have placed a tremendous economic pressure on an industry that is vital to my district and is threatening the livelihood of many of the Mississippi working families I represent.

We need a multi-pronged strategy to find our way out of this energy crisis. We need to reduce our dependence on foreign oil and we must invest in homegrown, alternative energy sources. Finally, we must investigate our energy commodities markets and ensure there is a level playing field when it comes to oil trading.

I look forward to hearing the testimony of my distinguished colleagues and I believe the testimony over the next 2 days will help us to separate the facts from the rhetoric in regards to energy prices within the Commodities markets.

It is my hope that this hearing will provide us with the information we need to provide bipartisan solutions to help stabilize the price of oil as quickly as possible.

The CHAIRMAN. We now will welcome the Members that have legislation introduced. I just asked my staff how this order was determined, and this is apparently kind of like the futures market. We are not exactly sure, but we hope that you are all okay with it.

And so first on the list here is the Honorable Jim Matheson from the Second Congressional District of Utah. We have many outstanding Members here from our leadership, Mr. Van Hollen, Mr. Larson, Ms. DeLauro, who worked with us so hard on the farm bill and has been a good ally of this Committee, her job as Appropriations Subcommittee Chairman, Mr. Stupak, who does great work for us in the Energy and Commerce Committee, and Mr. Welch, who has gotten to be a good friend of mine from Vermont, who has been a liaison with the freshman class for us, and we welcome you all here today.

So, Mr. Matheson, we are going to give you 5 minutes each to summarize your statements. The full statements will be made part of the record. Welcome to the Committee, and we look forward to the process.

## STATEMENT OF HON. JIM MATHESON, A REPRESENTATIVE IN CONGRESS FROM UTAH

Mr. MATHESON. Well, Chairman Peterson and Ranking Member Goodlatte, I really appreciate the opportunity to testify today, and I am glad you are holding this series of hearing.

It was just 2 weeks ago the House passed the Energy Markets Emergency Act of 2008, almost unanimously, and that called for the CFTC to exercise emergency powers to "curb the role of excessive speculation in any contract market." I supported this bill, and I was pleased to work with you, Mr. Chairman, on that bill.

Now, while that bill prompted the Administration's performance oversight duties, many in Congress still believe there is room to address the role of speculation in oil prices.

While some had advocated for doing nothing and others believe that we should simply bar index investors and others from the energy commodity markets altogether, I believe what we really need is a level playing field that is transparent and accountable.

Our goal as a Congress should be to make sure that the regulator, the CFTC, has the ability to ensure undue manipulation isn't taking place in the markets.

This Committee has a very difficult problem to consider with no easy solutions. The energy commodity markets are complex. Simply laying blame on traders ignores the aggregate problems we are seeing in terms of speculation in these markets.

I used to work in the energy business before I came to Congress. I managed a co-op of natural gas users. I was involved in arranging supply and transportation, and I also implemented hedging strategies using futures contracts for the members of that co-op. From my experience, I know that there is value in the presence of a viable, transparent futures market. These markets allow for greater

efficiency in our economy and provide critical outlets for hedging against price risks.

Futures markets work because they allow stakeholders to assess risks, to hedge and protect against losses, and to secure gains through speculation. There is a legitimate role for speculation, particularly in the futures market, this just isn't well understood. That is because the futures markets work best when liquidity exists to stabilize prices.

By which I mean that if I am an airline CEO or a petroleum refiner, and I am looking to protect my business against future price increases or decreases, I want to have the option to hedge that risk. I want to be able to lock in a price today so that I have some kind of insurance and certainly against the future when higher or lower prices might affect my business.

However, in order for a business owner to hedge his exposure to movement in oil prices, there must be someone in the marketplace who is willing to assume that risk. The entity that takes the risk is betting that the price will either rise or fall and that they will make money. They are speculating. For every contract, this may sound basic, but we all ought to remember this. For every contract, there is both a buyer and a seller. You can't have one without the other.

The problem before us today is not black and white. It exists in many shades of gray, and that is why we need to be looking for solutions that force all the players to play by the same rules. That doesn't happen today.

That is because current law allows people to trade on foreign exchanges under something called the foreign boards of trade provision under the Commodity Exchange Act.

Current law allows the CFTC to determine if a foreign board of trade, such as ICE Futures based in London, is already regulated in its country of residence. If it is, current law says that the CFTC doesn't need to regulate it here in the U.S.

That might work in theory, if every country had the same financial rules. The United Kingdom does have a regulatory system, and it does oversee ICE Futures, which is a good start.

The problem is that the CFTC hasn't been getting all the data about trades occurring on the ICE exchange. The other problem is that ICE Futures does not have the same position limits on trades as domestic exchanges do, potentially leading to massive price-affecting holdings that would go undetected by U.S. regulators.

So if I were a trader and I wanted to buy more energy commodities than NYMEX would allow, because it has limits, I could go over to ICE Futures via its electronic exchange in Atlanta, and buy as many futures as I wanted.

That doesn't make sense. Everyone who wants to trade in the U.S. energy futures, especially in West Texas crude or natural gas, should be subject to the same rules.

Now, there is good news to report on this. On June 17 the CFTC announced a new agreement with ICE Futures Europe to require ICE Futures to adopt "equivalent U.S. position limits and accountability levels," on West Texas crude. CFTC has also reached an agreement with the Financial Services Authority, the U.K. regulatory counterpart, by which it will receive data on large positions.

This data will be incorporated into the CFTC's weekly Commitments of Traders reports.

Just this past Monday, the CFTC also amended its No Action letter to the Dubai Mercantile Exchange in almost exactly the same way. This is very encouraging, and I think we are on the right track.

Now, Congress needs to ensure that these positive developments are enshrined in statute to ensure that the CFTC's new policy is consistently applied going forward.

While the idea of creating appropriate regulation to stop excessive market manipulation is appealing, I do want to say we should approach this issue with caution. If legislation goes too far, it could drive a significant amount of business that is taking place today in the U.S., offshore.

That is why I would caution against overreaching and why I think that we need to look at reasonable solutions. Congressman Charlie Melancon and I have introduced a bill which we think helps address this problem, H.R. 6284, the Close the London Loophole Act of 2008.

This bill requires foreign boards of trade to comply with all U.S. registration and regulatory requirements if they offer contracts that can be settled by physical delivery within the United States. It provides the CFTC with full enforcement authority over traders within the U.S. who trade on an exchange outside the U.S.

It also requires the CFTC to set up agreements with foreign exchanges with respect to comparable speculative limits and reporting requirements for any exchange that is trading U.S. energy commodities before the exchange is allowed to establish direct trading terminals in the U.S.

Our bill would effectively codify the CFTC's recent actions to require such reporting and limits with ICE Futures, and it would apply this effort to future agreements. This is important because the CFTC agreement with ICE Futures does not apply to other markets. The CFTC has issued No Action letters granting regulatory waivers to other foreign markets, so it is important we address this issue to make it more comprehensive in nature.

Unfortunately, Congressman Melancon could not be here today to testify as well, and I offer this testimony on the part of both of us. I would like to say that our bill has companion legislation in the U.S. Senate, authored by Senator Levin of Michigan.

Mr. Chairman, I appreciate the opportunity to testify and look forward to answering your questions.

[The prepared statement of Mr. Matheson follows:]

PREPARED STATEMENT OF HON. JIM MATHESON, A REPRESENTATIVE IN CONGRESS FROM UTAH

Thank you, Chairman Peterson and Ranking Member Goodlatte for inviting me to testify before the Agriculture Committee today. I also thank you for holding a series of hearings on the issue of energy market manipulation.

Just a couple weeks ago, the House passed the Energy Markets Emergency Act of 2008, almost unanimously. It called on the CFTC to exercise emergency powers to "curb the role of excessive speculation in any contract market." I supported this bill and I was pleased to work with you, Mr. Chairman on this bill.

While the Energy Markets Emergency Act of 2008 effectively prompts the administration to perform its oversight duties, many in Congress still believe there is room to address the role of speculation in oil prices.

While some have advocated for doing nothing and others believe that we should simply bar index investors and others from the energy commodity markets altogether, I believe what we really need is a level playing field that is transparent and accountable.

Our goal should be to make sure that the regulator—the CFTC—has the ability to ensure undue manipulation isn't taking place in the markets.

This Committee has a very difficult problem to consider, with no easy solutions. The energy commodity markets are complex. Simply laying blame on traders ignores the aggregate problems we're seeing, in terms of speculation in these markets.

I used to work in the energy business. I managed a co-op of natural gas users. I was involved in arranging supply, transportation, and implementing hedging strategies for members of the co-op. From my experience, I know that there is value in the presence of a viable, transparent futures market. These markets allow for greater efficiency in our economy, and provide critical outlets for hedging against price risks.

Futures markets work because they allow investors to assess risk, to hedge and protect against losses, and to secure gains through speculation. There is a legitimate role for speculation, particularly in the futures market, that just isn't well understood. That's because the futures markets works best when liquidity exists to stabilize prices.

By which I mean that if I am an airline CEO or a petroleum refiner, and I'm looking to protect my business against future price increases or decreases, I want to have the option to hedge. I want to be able to lock in today's price so that I have some kind of insurance against the future when a higher or lower price might damage my business.

However, in order for a business owner to hedge his/her exposure to high oil prices, there must be someone in the marketplace who is willing to assume my risk. The entity that takes that risk is betting that the price will either rise or fall and that they will make money. They are speculating. For every contract, there is both a buyer and a seller. You cannot have one without the other.

The problem before us today is not black and white. It exists in shades of grey. That's why we need to be looking for solutions that force all the players to play by the same rules. That does not happen today.

That's because the current law allows people to trade on foreign exchanges, under something called the foreign boards of trade provision under the Commodity Exchange Act.

Current law allows the CFTC to determine if a Foreign Board of Trade—such as ICE Futures, based in London—is already regulated in its country of residence. If it is, current law says that the CFTC doesn't need to regulate it here in the U.S.

That might work in theory, if every nation had the same financial rules. The U.K. does have a regulatory system and it does oversee ICE Futures, which is a good start.

However, the problem is that the CFTC hasn't been getting all the data about trades occurring on the ICE exchange. The other problem is that ICE Futures does not have the same position limits on trades as domestic exchanges do, potentially leading to massive, price-affecting holdings that would go undetected by U.S. regulators.

So if I were a trader and I wanted to buy more energy commodities than NYMEX would allow, because it has limits, I could go over to ICE Futures, via its electronic exchange in Atlanta and buy as many futures as I wanted.

This doesn't make sense. Everyone who wants to trade in U.S. energy futures, especially in West Texas crude oil or natural gas, should be subject to the same rules.

Now, there is good news to report too. On June 17th, the CFTC announced a new agreement with ICE Futures Europe to require ICE Futures to adopt "equivalent U.S. position limits and accountability levels" on West Texas crude oil. CFTC has also reached an agreement with the Financial Services Authority, the UK regulatory counterpart, by which it will receive data on large positions. This data will be incorporated into the CFTC's weekly Commitments of Traders reports.

Just this past Monday, the CFTC also amended its No Action letter to the Dubai Mercantile Exchange in almost exactly the same way. This is very encouraging and I think we're on the right track. Now, Congress needs to ensure that these positive developments are enshrined in statute to ensure that the CFTC's new policy is consistently applied going forward.

While the idea of creating appropriate regulation to stop excessive market manipulation is appealing, we should approach this issue with caution. If legislation goes too far, it could drive a significant amount of business that is taking place in the U.S. today, offshore.

That is why I would caution against overreaching and why I think that we need to look at reasonable solutions today. Congressman Charlie Melancon and I have introduced a bill that we think addresses the problem—H.R. 6284, the Close the London Loophole Act.

The Matheson-Melancon bill requires foreign boards of trades to comply with all U.S. registration and regulatory requirements if they offer contracts that can be settled by physical delivery within the United States. It provides the CFTC with full enforcement authority over traders within the U.S. who trade on an exchange outside the U.S.

It also requires the CFTC to set up agreements with foreign exchanges with respect to comparable speculative limits (they exist on NYMEX already) and reporting requirements for any exchange that is trading U.S. energy commodities before the exchange is allowed to establish direct trading terminals in the U.S.

Our bill would effectively codify the CFTC's recent action to require such reporting and limits from ICE Futures and it would apply this effort to future agreements. This is important because the CFTC agreement with ICE Futures does not apply to other markets. The CFTC has also issued No Action letters granting regulatory waivers to foreign markets, including the Dubai Mercantile Exchange, so it is important that we address this issue as soon as possible.

Unfortunately, Congressman Melancon could not be here today to testify as well and I offer my testimony for both of us. I'd also like to say that our bill has companion legislation in the Senate, authored by Senator Levin of Michigan.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, and next we will move to Mr. Van Hollen from the Eighth District of Maryland, a Member of our leadership, and welcome to the Committee. We look forward to your testimony.

## STATEMENT OF HON. CHRIS VAN HOLLEN, A REPRESENTATIVE IN CONGRESS FROM MARYLAND

Mr. VAN HOLLEN. Thank you, Mr. Chairman. I would like to start by commending you, Chairman Peterson, and Ranking Member Goodlatte, as well as Subcommittee Chairman Etheridge and Mr. Moran, the Ranking Subcommittee Member, for your leadership and the substantial amount of work this Committee has already done looking into this issue and the legislation in connection with the farm bill.

I would also like to recognize my colleagues here for their work; Bart Stupak, who has had a longstanding interest in this area and done a lot of work, Mr. Larson, Mr. Welch, Mr. Matheson, and my colleague Rosa DeLauro, with whom I have introduced legislation entitled, the Energy Markets Anti-Manipulation and Integrity Restoration Act, which we will discuss today.

And as you said, Mr. Chairman, at the outset, I hope that under the leadership of this Committee we can find common ground going forward in this area.

I do think at the outset it is important to remember why futures markets exist in the first place, and I think the easiest thing to do is take the definition of the CFTC, which says, "The futures markets serve the important function providing a means for price discovery and offsetting price risk." So long as the price discovered by the futures market accurately reflects the forces of supply and demand, producers and consumers of commodities can go to the futures market and hedge with confidence in order to offset their price risk.

But when excessive speculation unhinged the futures markets from supply and demand fundamentals, hedgers begin to lose confidence in the price discovery function of futures markets, and the

distorted futures prices transmitted to the spot market winds up overcharging consumers for the energy they rely on every day, our constituents.

Let me say at the outset that I do not believe that excessive speculation is the sole cause or even the major cause of the recent surge in energy prices. Without question, other factors, such as increasing worldwide demand in countries like India and China, supply disruptions in Nigeria, and devaluation of the dollar, have all played a role.

However, a growing chorus of Congressional testimony and market commentary from a wide range of credible and authoritative sources has concluded that the run-up in today's price of oil cannot be explained by the forces of supply and demand alone. They include the Senate Permanent Subcommittee on Investigations; the IMF; the Japanese Ministry of Economy, Trade and Industry; respected media outlets from *The Washington Post* to *Fortune* magazine; and stakeholders including large institutional investors, hedge fund managers, oil company executives, financial analysts, economists, consumer advocates, and academic experts. They increasingly point to a meaningful speculation premium in today's price of oil. A May, 2008, market report from the respected institutional financial consulting firm, Greenwich Associates, summed it up this way, "The entry of new financial or speculative investors into global commodities markets is feeling the dramatic run-up in prices."

There are some, including the Oppenheimer Managing Director and Senior Oil Analyst Fadel Gheit, who put the speculation premium as high as 50 percent. I don't think anybody knows for sure exactly how big this premium is. It is difficult to quantify. I do think it is above zero, and so long as it is above zero, so long as it is not based solely on the force of supply and demand, I think we should act to wring out that excessive speculation in the market.

The legislation that Ms. DeLauro and I have introduced offers what we believe are three important steps Congress can take to address these issues.

First, it would build upon the reform this Committee began in the most recent farm bill. By adding energy commodities to the definition of an exempt commodity under the Commodity Exchange Act, effectively treating energy commodities the same way this Committee has already decided to treat agriculture commodities under current law. This Committee has jurisdiction over those agriculture commodities. We are saying treat them under the law, treat energy commodities the same way as you have chosen to treat agricultural commodities.

Taking this step would close the door even more firmly on the so-called Enron Loophole by requiring that energy futures contracts trade on Designated Commercial Markets or Designated Transaction Execution Facilities, unless the CFTC provides a specific exemption as it currently can do for agricultural commodities.

Second, to ensure that swaps are not used to circumvent the regulation and CFTC oversight intended by adding energy commodities to the CEA's definition of an exempt commodity, we bring those swaps under the jurisdiction of the CFTC.

Finally, H.R. 6341 would close what has become known, as my colleague, Mr. Matheson, referred to it as the, it is the London-Dubai Loophole, by amending the Commodity Exchange Act to forbid an exchange from being deemed an unregulated foreign entity if its trading affiliate or trading infrastructure is in the United States, and it offers a U.S. contract that significantly affects price discovery.

In that regard, I believe that our constituents would probably assume that a market like ICE, the IntercontinentalExchange, operating inside the United States and facilitating an estimated 30 percent of the trade in our U.S. West Texas Intermediate futures contract would be fully subject to CFTC oversight and U.S. law.

Like Members of this Committee, I have a long-term concern about the escalating worldwide demand for energy and the impact that it will have on the price of oil and fuels derived from oil as we move forward. While this concern makes me and many an ardent advocate for accelerating the development and deployment of the next generation of energy alternatives, it also causes me to conclude that we must make every effort to ensure that we do not exacerbate the current challenge for our constituents by layering on an additional speculation premium.

Moreover, in light of the dramatically increased speculative inflows into the energy futures markets and the unprecedented recomposition of these markets' hedger-speculated participation ratios over the past 10 years that coincide with a staggering 1,000 percent jump in the price of a barrel of oil over the same period of time, I believe the burden is on those who would argue for maintaining the *status quo* to convincingly establish that excessive speculation is not having an impact on today's energy prices.

Furthermore, those who would maintain current law must demonstrate that the exceptions we have so far permitted to persist under the Commodity Exchange Act do, in fact, support rather than weaken the primary functions of price discovery and offsetting price risk necessary for a healthy energy futures marketplace.

I appreciate the opportunity to testify today and look forward to working with you, Mr. Chairman, Ranking Member Goodlatte, and other Members of the Committee as we move forward.

Thank you.

[The prepared statement of Mr. Van Hollen follows:]

PREPARED STATEMENT OF HON. CHRIS VAN HOLLEN, A REPRESENTATIVE IN CONGRESS FROM MARYLAND

Chairman Peterson, Ranking Member Goodlatte, and Members of the Committee:

First of all, I'd like to commend Chairman Peterson, Ranking Member Goodlatte, Subcommittee Chairman Etheridge and the rest of the Committee for the substantial amount of work that has already been done on this issue. I'd also like to recognize Rep. Bart Stupak (D–MI) for his longstanding interest in this area, Rep. John Larson (D–CT) for his diligent attention to this matter, Rep. Jim Matheson (D–UT) for the personal perspective he brings to this discussion, and of course, Rep. Rosa DeLauro (D–CT) with whom I have introduced the Energy Markets Anti-Manipulation and Integrity Restoration Act (H.R. 6341) I will be discussing today.

At the outset, I think it's useful to remember why futures markets exist in the first place. According to the Commodity Futures Trading Commission (CFTC), "the futures markets . . . serve the important function of providing a means for price discovery and offsetting price risk." So long as the price discovered by the futures markets accurately reflects the forces of supply and demand, producers and con-

sumers of commodities can go to the futures markets and hedge with confidence in order to offset their price risk. But when excessive speculation unhinges the futures markets from supply and demand fundamentals, hedgers begin to lose confidence in the price discovery function of futures markets, and the distorted futures price transmitted to the spot market winds up overcharging consumers for the energy they rely on every day.

Let me say at the outset that I do not believe excessive speculation is the sole cause of the recent surge in energy prices. Without question, other factors—such as increasing worldwide demand in countries like India and China, supply disruptions in Nigeria, and the devaluation of the dollar—have all played a role.

However, a growing chorus of congressional testimony and market commentary from a wide range of credible and authoritative sources has concluded that the run-up in today's price of oil cannot be explained by the forces of supply and demand alone. Among those sources are the Senate Permanent Subcommittee on Investigations, the International Monetary Fund and the Japanese Ministry of Economy, Trade and Industry (METI). Respected media outlets from *The Washington Post* to *Fortune* magazine have voiced similar concerns. And stakeholders including large institutional investors, hedge fund managers, oil company executives, financial analysts, economists, consumer advocates and academic experts increasingly point to a meaningful speculation premium in today's price of oil. A May 2008 market report from the respected institutional financial consulting firm Greenwich Associates summed it up this way: "The entry of new financial or speculative investors into global commodities markets is fueling the dramatic run-up in prices."

Some experts—like Oppenheimer Managing Director and Senior Oil Analyst Fadel Gheit—put today's speculation premium in the oil markets in excess of 50%, arguing that true market fundamentals imply a price of approximately $65 a barrel. Since it is difficult to quantify the role of market speculation with mathematic precision, it is hard to know the exact magnitude of today's speculation premium. But I do not believe that it is zero. And that is why I believe we must act.

The Energy Markets Anti-Manipulation and Integrity Restoration Act (H.R. 6341) that I have offered with my colleague Rosa DeLauro and others proposes what we believe represents the three most important steps Congress can take to eliminate the possibility of any outright manipulation occurring in unregulated markets and to wring excessive speculation out of today's energy marketplace.

First, H.R. 6341 would build upon the reform this Committee began in the most recent farm bill by adding energy commodities to the definition of an exempt commodity under the Commodity Exchange Act (CEA), effectively treating energy commodities the same way we treat agricultural commodities under current law. Taking this step would close the door even more firmly on the so-called "Enron Loophole" by requiring that energy futures contracts trade on Designated Commercial Markets (DCMs) or Designated Transaction Execution Facilities (DTEFs), unless the CFTC provides a specific exemption.

Second, to ensure that swaps are not used to circumvent the regulation and CFTC oversight intended by adding energy commodities to the CEA's definition of an exempt commodity, H.R. 6341 would also add energy commodities to the definition of excluded swap transactions under the Commodity Exchange Act.

Finally, H.R. 6341 would close what has come to be known as the London-Dubai loophole by amending the Commodity Exchange Act to forbid an exchange from being deemed an unregulated foreign entity if its trading affiliate or trading infrastructure is in the United States, and it offers a U.S. contract that significantly affects price discovery.

In that regard, I think most of our constituents would probably assume that a market like the Intercontinental Exchange (ICE Futures Europe) operating inside the United States and facilitating an estimated 30% of the trade in our U.S. West Texas Intermediate (WTI) futures contracts would be fully subject to CFTC oversight and U.S. law. But as all of us in this room understand, that is currently not the case. When it comes to the integrity and transparency of energy markets operating inside the United States, we simply cannot outsource the responsibility for policing those markets to foreign governments or regulatory authorities.

Like Members of this Committee, I have a long term concern about the escalating worldwide demand for energy and the impact that it will have on the price of oil and fuels derived from oil going forward. While this concern makes me an ardent advocate for accelerating the development and deployment of next generation energy alternatives, it also causes me to conclude that we must make every effort to ensure that we do not exacerbate the current challenge for our constituents by layering an additional speculation premium on top of it. Moreover, in light of the dramatically increased speculative inflows into the energy futures markets, and the unprecedented re-composition of these markets' hedger-speculator participation ratios over

the past 10 years coinciding with a staggering 1,000% jump in the price of a barrel of oil, I believe the burden is on those who would argue for maintaining the *status quo* to convincingly establish against the available evidence that excessive speculation is not having an impact on today's energy prices. Furthermore, proponents of maintaining current law must definitively demonstrate that the exceptions we have thus far permitted to persist in the Commodity Exchange Act do in fact support the primary functions of price discovery and offsetting price risk necessary for a healthy energy futures marketplace.

I appreciate the opportunity to testify today, and I stand ready to work with Members of the Committee to fashion language that achieves our common goals on this important public policy issue.

The CHAIRMAN. Thank you very much, Mr. Van Hollen. I appreciate your testimony.

Now Chairwoman Rosa DeLauro, a good friend of this Committee. We worked with her a lot on the different issues that affect both of our Committees. We appreciate you being with us from the Third District of Connecticut. Rosa.

**STATEMENT OF HON. ROSA L. DELAURO, A REPRESENTATIVE IN CONGRESS FROM CONNECTICUT**

Ms. DELAURO. Thank you very much, Mr. Chairman, and if it is all right with you, maybe I can be *ex officio* on this Committee. We have spent a lot of time together and a lot of very productive time, and I am happy to join with you and Ranking Member Goodlatte and Mr. Etheridge, Mr. Moran, and the entire Committee. And I thank you for allowing me to submit testimony today.

I also, as my colleagues have, want to recognize them, Mr. Matheson, Mr. Van Hollen, who I have introduced legislation with, Mr. Stupak, Mr. Larson, Mr. Welch, all who have a consuming interest in this area and the issue of excessive speculation and the energy futures market is critical and does have an impact on our entire economy.

I want to say, Mr. Chairman, to be sure, and I understand this, that I am not an economist, nor do I profess to study this issue with an academic's eye. But I care about this subject deeply because it affects my constituents and our economy as a whole. We know that soaring gas prices are shattering everyone's budget, killing middle-class families trying to make ends meet, farmers harvesting their crops, truckers traveling our highways. High gas prices threaten to wipe out the holidays that families have been looking forward to all year. Families in Connecticut and across the country want to know what government is going to do and what the oil companies are going to do. With gas at a national average of $4.11 a gallon, $1.18 more than this time last year, and diesel hovering at around $5, energy prices are a suffocating tax on our entire economy.

We are in a crisis, and as such, we need to look at every aspect that could potentially affect energy prices. Of course, we must take into account factors such as a weak dollar, strong demand from emerging economies, geopolitical tensions in oil-producing regions, and supply disruptions. But we must also do everything in our power to protect consumers from unregulated market manipulation and excessive energy speculation.

From the Senate Permanent Subcommittee on Investigations to the International Monetary Fund, experts refer to the mass migration of energy futures trading, off regulated exchanges onto exempt

commercial markets as a possible factor distorting energy prices in a way that enriches speculators at the expense of the American consumer.

That is why I have come to believe that such activity is responsible for a big part of the commodity price increases that we are experiencing. Doing nothing in this area in my view is not an option. We must continue to empower the Commodity Futures Trading Commission to do its regulatory job. As its mission reveals, the CFTC's primary function is, "To protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options and to foster open, competitive, and financially-sound futures and option markets."

And as the Chair of the House Appropriations Subcommittee on Agriculture, I have worked to ensure that the CFTC has the resources that it needs to act and fulfill its mission. Yet, as the GAO's report, *Trends in Energy Derivatives Market Raises Questions About CFTC's Oversight,* they found last fall, and again, "Trading in these markets, specifically electronic commercial markets and over-the-counter markets, is much less transparent than trading on futures exchanges and comprehensive data are not available because these energy markets are not regulated." Clearly we need a full market transparency, and we need to hold the CFTC's feet to the fire to do its job.

With your leadership, Chairman Peterson, and a group of our colleagues, we made progress in this area when we passed legislation directing the CFTC to examine unregulated speculation in our futures markets and to use its emergency powers to stop market manipulations. And with the farm bill your Committee tackled the need to bring transparency to energy trading environments by creating a new regulatory regime for certain over-the-counter energy derivatives markets, subjecting them to a number of exchange-like regulations.

But as I understand it, we have more to do to ensure excessive speculation is not distorting energy prices and the CFTC has access to over-the-counter markets and foreign boards of trade which still remain obscure. I believe we can bring further transparency to the futures markets if we fully close the so-called, Enron Loophole, and the Foreign Board of Trade Loophole.

That is why Congressman Van Hollen and I have introduced H.R. 6314, the Energy Markets Anti-Manipulation and Integrity Restoration Act, which would do two simple things. First, close the so-called, Enron Loophole, by adding energy commodities and related swaps to the list of items that cannot be traded on unregulated exempt commercial markets. And second, close the London-Dubai Foreign Board of Trade Loophole by forbidding an exchange from being deemed an unregulated foreign entity if its trading affiliate or trading infrastructure is in the United States, and it trades a U.S. delivered contract that significantly affects price discovery.

Our legislation would go a long way toward preventing improper speculation, ensuring real transparency, and bringing oversight and enforcement to our energy and agricultural futures markets. It would also restore the balance that has been missing since 2000, when the Commodity Futures Modernization Act placed large seg-

ments of the commodities futures market outside of CFTC jurisdiction and allowed for virtually unregulated, over-the-counter, and electronic trading of many commodities futures.

Mr. Chairman, the fact is some will always argue against regulating market forces. But we have seen the consequences of that kind of approach over the last 8 years and even further back. From the savings and loans to the subprime mortgage crisis to the Federal Reserve backed bailout of Bear Sterns, speculative bubbles emerge. If regulators do nothing, consumers pay. It is a familiar cycle, and the same thing I am afraid may be happening with food prices.

Mr. Chairman, it is time for us to act, change the way we oversee our futures markets, and restore balance to the energy marketplace. It is time to protect consumers.

And I thank the Committee and look forward to working with you.

[The prepared statement of Ms. DeLauro follows:]

PREPARED STATEMENT OF HON. ROSA L. DELAURO, A REPRESENTATIVE IN CONGRESS FROM CONNECTICUT

I want to thank Chairman Peterson, Ranking Member Goodlatte and Members of the Committee for having this important hearing and for allowing me to submit testimony today. The issue of excessive speculation in the energy futures markets is critical and has an impact on our entire economy.

I also want to recognize my friend and colleague, Rep. Chris Van Hollen and thank him for allowing me to work with him on this important issue. Chris was one of the first to highlight the potential role of improper speculation in our energy markets and has been a real advocate pushing us all in the Congress to take decisive action.

Mr. Chairman, to be sure, I am not an economist; nor do I profess to study this issue with an academic's eye. But care about this subject deeply because it affects my constituents and our economy as a whole. We know that soaring gas prices are shattering everyone's budget, killing middle class families trying to make ends meet, farmers harvesting their crops, truckers traveling our highways. High gas prices threaten to wipe out the holidays that families have been looking forward to all year. Families in Connecticut, and across the country, want to know what government is going to do and what the oil companies are going to do.

With gas at a national average of $4.11 a gallon—$1.18 more than this time last year, and diesel hovering at $5 dollars—energy prices are a suffocating tax on our entire economy.

We are in a crisis, and as such, we need to look at every aspect that could potentially affect energy prices. Of course, we must take into account factors such as a weak dollar, strong demand from emerging economies, geopolitical tensions in oil-producing regions and supply disruptions. But we must also do everything in our power to protect consumers from unregulated market manipulation and excessive energy speculation. Experts refer to trading energy futures off regulated exchanges onto less transparent exchanges as a possible factor distorting energy prices in a way that enriches speculators at the expense of the American consumer. I have come to believe that such activity is responsible for a big part of the commodity price increases we are experiencing. Doing nothing in this area is not an option.

That is why we must continue to empower the Commodity Futures Trading Commission to do its regulatory job. As its mission reveals, the CFTC's primary function is "to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets." Yet, as the GAO's report "Trends in Energy Derivatives Markets Raises Questions About CFTC'S Oversight" [GAO–08–25, October 19, 2007] found last fall, "trading in these markets-specifically electronic commercial markets and over-the-counter (OTC) markets—is much less transparent than trading on futures exchanges, and comprehensive data are not available because these energy markets are not regulated." Clearly we need full market transparency and we need to hold the CFTC's feet to the fire to do its job.

With your leadership, Chairman Peterson, and a group of our colleagues, we made progress in this area when we passed legislation directing the CFTC to examine unregulated speculation in our futures markets and to use its emergency powers to stop market manipulation. And with the farm bill your Committee tackled the need to bring transparency to energy trading environments by creating a new regulatory regime for certain over-the-counter (OTC) energy derivatives markets, subjecting them to a number of exchange-like regulations.

But as I understand it, we have more to do to ensure excessive speculation is not distorting energy prices and the CFTC has access to the over-the-counter markets and foreign boards of trade which still remain obscure. I believe, we can bring further transparency to the futures markets if we fully close the so-called "Enron-loophole" and the "Foreign Board of Trade (FBOT) Loophole."

That is why, Congressman Van Hollen and I have introduced *The Energy Markets Anti-Manipulation and Integrity Restoration Act*—which would do two simple things: first, close the so-called "Enron Loophole" by adding energy commodities and related swaps to the list of items that cannot be traded on unregulated exempt commercial markets and second, close the London-Dubai "Foreign Board of Trade (FBOT) Loophole" by forbidding an exchange from being deemed an unregulated foreign entity if its trading affiliate or trading infrastructure is in the U.S., and it trades a U.S. contract that significantly affects price discovery.

Our legislation would go a long way toward preventing improper speculation, ensuring real transparency, and bringing oversight and enforcement to our energy and agricultural futures markets. It would also restore the balance that has been missing since 2000 when The Commodity Futures Modernization Act ("CFMA") placed large segments of the commodities futures market outside CFTC jurisdiction and allowed for virtually unregulated over-the-counter and electronic trading of many commodities futures.

Mr. Chairman, the fact is some will always argue against regulating market forces. But we have seen the consequences of that kind of approach over the last 8 years. It is time to change the way we oversee our futures markets and restore balance to the energy marketplace.

The CHAIRMAN. Thank you very much. We appreciate your testimony.

Next we have Mr. Stupak from the First District of Michigan, esteemed Member of the Energy and Commerce Committee and very active on this issue. Welcome to the Committee.

## STATEMENT OF HON. BART STUPAK, A REPRESENTATIVE IN CONGRESS FROM MICHIGAN

Mr. STUPAK. Well, thank you, Mr. Chairman, and thank you Members of this Committee. I want to thank Mr. Etheridge and all the Members up here at this front table. In fact, all Members who put forth legislative proposals to address the run-up in energy costs.

The price of crude oil has doubled over the past year. It is now $136 a barrel. Gasoline prices have increased more than $1.14. It is now at $4.11. Diesel prices have increased $1.90 to $4.73 per gallon.

As a result, industries across the country are hurting. Airlines are eliminating service to more than 100 cities, laying off thousands of workers and projecting up to $13 billion in losses this year due to jet fuel price increases that cannot be passed onto customers.

Truck drivers are going out of business and many more are just parking their trucks because they actually end up losing money after paying so much for diesel. Farmers face increased costs in all stages of their operations, from planting and harvesting to transporting their product to market. As a result, high energy prices have caused significant increases in the cost of food.

There is no way to justify the doubling of oil prices based on supply and demand.

In October of 2007, the Government Accountability Office released its report on the ability of the Commodities Futures Trading Commission to properly monitor energy markets to prevent manipulation. The GAO found that the volume of trading in energy commodities has skyrocketed as our first chart shows right here. Specifically, after the Enron Loophole was enacted in 2000, the GAO also found that while trading has doubled since 2002, the number of CFTC staff monitoring these markets has declined.

And the numbers back this up. If we look at *Chart 2* between September 30, 2003, and May 6, 2008, traders holding crude oil contracts jumped from 714,000 contracts traded to more than three million contracts traded. From 714 contracts to more than three million contracts traded. This is a 425 percent increase in trading of oil futures in less than 5 years.

Since 2003, commodity index speculation has increased 1,900 percent, from an estimated $13 billion to $260 billion. Lehman Brothers recently estimated that crude oil prices go up about 1.5¢ for every $100 million in commodity index investments.

By the Lehman Brothers estimate, the 1,900 percent increase in commodity index speculation has inflated the price of crude oil by approximately $37 a barrel. Other experts estimate it could be even more.

On June 23, 2008, the Oversight Investigation Subcommittee that I Chair held a hearing on the effect speculators have on our energy prices. This was the sixth hearing that the Energy and Commerce Committee has held on gas prices over the past 2 years. Fadel Gheit, Managing Director and Senior Oil Analyst at Oppenheimer and Company, testified that, "I firmly believe that the current record oil price in excess of $135 a barrel is inflated. I believe, based on supply and demand fundamentals, crude oil prices should not be above $60 per barrel."

If we take a look at *Chart 3*, in 2000, physical hedgers, businesses like airlines that need to hedge to ensure a stable price for fuel in future months, accounted for 63 percent of the oil futures market. Speculators accounted for 37 percent. By April of 2008, physical hedgers only controlled 29 percent of the market. What we now know is approximately 71 percent of the market has been taken over by swap dealers and speculators, a considerable majority of whom have no physical stake in the market. Over the past 8 years there has been a dramatic shift as physical hedgers continually represent a smaller and smaller portion of the market.

The New York Mercantile Exchange has granted 117 hedging exemptions since 2006, for West Texas Intermediate crude contracts, many of which are for swap dealers without physical hedging positions. This excessive speculation is a significant factor in the price Americans are paying for gasoline, diesel, and home heating oil. Even the executives of the major U.S. oil companies recognize this.

On April 1, 2008, testimony before the Select Committee on Global Warming, Mr. John Lowe, Executive Vice President of ConocoPhillips said, "It is likely that the large inflow of capital into the commodity funds is temporarily exaggerating upward oil price movements."

At the same hearing Mr. Peter Robertson, Vice Chairman of Chevron noted, "a flight to commodities," adding that an economist was quoted in *The Wall Street Journal* saying, "Crude prices have decoupled from the forces controlling the underlying physical flows of the commodity."

And at the May 21, 2008, Senate Judiciary hearing, Shell President John Hofmeister agreed that the price of crude has been inflated, saying that the proper range for oil prices should be, "somewhere between $35 and $65 a barrel."

Look at the next chart with the International Monetary Fund. In May of 2008, the IMF compared crude oil over the past 30 years to the price of gold. Gold prices are not dependent on supply and demand and have been viewed as a highly speculative commodity. The IMF analysis shows crude oil prices track increases in gold prices.

If we take a look at *Chart 4,* what this means is that oil has been transformed from an energy source into a financial asset like gold, where much of the buying and selling is driven by speculators instead of the producers and consumers. Oil is morphed from a commodity into a financial asset, traded for its speculative value instead of its energy value.

Even the Saudi Oil Minister has argued that high oil prices are due to excessive speculation in the markets.

As former Secretary of Labor Robert Reich noted on National Public Radio a few weeks ago, the problem is the government's failure to curb excessive speculation.

The Commodity Exchange Act recognizes the dangers of excessive speculation. Section 4A of the Act states, "Excessive speculation in any commodity under contracts for sale of such commodity for future delivery made on or subject to the rules of contract markets or derivatives transaction execution facilities causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce."

As a result, Section 4A provides the CFTC with the authority to set position limits or take other actions necessary to curb excessive speculation.

However, there are significant loopholes that exempt energy trading from these protections against excessive speculation: the Enron Loophole, the foreign boards of trade No Action letters, the Swaps Loophole, and the *Bona Fide* Hedging Exemption. While the recently-passed farm bill addressed the Enron Loophole for electronic trading for natural gas, a significant portion of the energy trading continues to be exempt from CFTC action to curb excessive speculation.

For 3 years I have looked into excessive speculation in the energy markets. My latest bill, the 2008, Prevent Unfair Manipulation of Prices, the PUMP Act, H.R. 6330, would end all of these exemptions, to ensure that excessive speculation is not driving these markets beyond the supply and demand fundamentals.

The PUMP Act, the most comprehensive energy speculation bill in Congress would address bilateral trades and require that bilateral trades be subject to CFTC oversight of foreign boards of trade. To clarify, CFTC's jurisdiction over these foreign boards of trade,

the PUMP Act would give the CFTC authority over these exchanges if they are using computer terminals in the United States or they are trading energy commodities that provide for a delivery point in the United States.

Swaps Loophole: Swaps are currently excluded from requirements for position limited to prevent excessive speculation. Today, 85 percent of the futures purchases tied to commodity index speculation come through swap dealers.

*Bona Fide* Hedging Exemption: Since 1991, 15 different investment banks have taken advantage of this exemption, even though they do not have legitimate anticipated business need. The PUMP Act would clarify that legitimate anticipated business needs does not mean energy speculators.

Strong aggregate position limits: By setting strong aggregate position limits over all markets, CFTC would be able to curb excessive speculation by making sure traders aren't amassing huge positions in a commodity in an attempt to play one exchange off of another.

By closing all of these loopholes and setting strong aggregate position limits, CFTC would be better able to monitor trades to prevent market manipulation and help eliminate the unreasonable inflation of energy prices caused by excessive speculation, helping to protect American consumers.

I bring this balloon because it helps to explain. No matter what loophole you close here with the Commodity Futures Trading Commission, you squeeze the Enron Loophole, we will go to Swaps. You squeeze Swaps, we go back to Enron. You do hedging or the *Bona Fide* Exemption or the Foreign Boards of Trade, it squeezes. You have to do it all. Whatever you do to one side of the balloon, it just rushes to the other. You have to get all of the these in order to stop this excessive speculation we see in the energy market.

If you don't believe excessive speculation is running up energy prices, keep this one thought in mind. On June 23 when I had my hearing, home heating oil was $3.98. Three days later the PUMP Act, my Act, was introduced in the Senate, and 3 days later home heating oil was $4.60. Yesterday to lock in or to hedge your home heating costs for this winter it will cost you $5.60 a gallon. That is more than a 20 percent increase in less than the last few days.

This is excessive speculation gone wild. The PUMP Act has 60 bipartisan cosponsors, been endorsed by several agricultural, airline, labor, and industry groups. The full list is part of my testimony. I have included a section-by-section description of the PUMP Act with my testimony.

I understand that there is essentially a war room that has been created by those on Wall Street who would like to continue to see energy trading remain in the dark. I am sure they are hiring a lot of lobbyists and are making every attempt they can to discredit those who are calling for reform.

However, I urge the Members of this Committee and my colleagues in the House to look at the evidence for themselves. We can either continue the *status quo* and excessive speculation can continue to inflate energy prices beyond the underlying supply and demand fundamentals, or we can stand up for our constituents who are facing high prices at the pump and our nation's businesses who

are struggling to cope with a weak economy and high production and transportation costs due to energy.

Excessive speculation is having a devastating effect on energy prices, causing a significant hardship for our entire economy. I look forward to working with Chairman Peterson and the Members of this Agriculture Committee and send legislation to the President's desk to address excessive speculation in the energy markets, to offer consumers relief at the pump.

Thank you, Mr. Chairman. I look forward to your questions and those of the Members of this Committee.

[The prepared statement of Mr. Stupak follows:]

PREPARED STATEMENT OF HON. BART STUPAK, A REPRESENTATIVE IN CONGRESS FROM MICHIGAN

The price of crude oil has doubled over the past year, oil is now $73.90 *more* than it was at this time last year. This spike has caused gasoline prices to increase $1.14 a gallon more than last year's highs, a national average of $4.10 per gallon. Diesel prices are up $1.82 per gallon compared to last year, up to $4.65 per gallon.

As a result, industries across the country are hurting. Airlines are eliminating service to 100 cities, laying off thousands of workers, and projecting up to $13 billion in losses this year due to jet fuel price increases that cannot be passed on to consumers.

Truck drivers are going out of business, and many more are just parking their trucks because they actually end up losing money after paying so much for diesel. Farmers face increased costs in all stages of their operations, from planting and harvesting to transporting their product to market. As a result, high energy prices have caused significant increases in the cost of food.

There is no way to justify the doubling of oil prices based on supply and demand.

In October 2007, the Government Accountability Office (GAO) released its report on the ability of the Commodities Futures Trading Commission (CFTC) to properly monitor energy markets to prevent manipulation. The GAO found that the volume of trading in energy commodities has skyrocketed, specifically after the Enron Loophole was enacted in 2000. The GAO also found that while trading has doubled since 2002, the number of CFTC staff monitoring these markets has declined.

And the numbers back this up. Between September 30, 2003 and May 6, 2008, traders holding crude oil contracts jumped from 714,000 contracts traded to more than three million contracts. This is a 425 percent increase in trading of oil futures in less than 5 years.

Since 2003, commodity index speculation has increased 1,900 percent, from an estimated $13 billion to $260 billion. Lehman Brothers recently estimated that the crude oil price goes up about 1.5 percent for every $100 million in commodity index investments.

By the Lehman Brothers estimate, the 1,900 percent increase in commodity index speculation has inflated the price of crude oil by approximately $37 a barrel. Other experts estimate it could be even more.

On June 23, 2008, the Oversight and Investigations Subcommittee that I Chair held a hearing on the effect speculators have on energy prices. Fadel Gheit, Managing Director and Senior Oil Analyst at Oppenheimer & Co. Inc. testified that: "I firmly believe that the current record oil price in excess of $135 per barrel is inflated. I believe, based on supply and demand fundamentals, **crude oil prices should not be above $60 per barrel.**"

In 2000, physical hedgers—businesses like airlines that need to hedge to ensure a stable price for fuel in future months—accounted for 63% of the oil futures market. Speculators accounted for 37%. By April 2008, physical hedgers only controlled 29% of the market. What we now know is that approximately 71% of the market has been taken over by swap dealers and speculators, a considerable majority of whom have no physical stake in the market. Over the past 8 years, there has been a dramatic shift as physical hedgers continually represent a smaller and smaller portion of the market.

The New York Mercantile Exchange (NYMEX) has granted 117 hedging exemptions since 2006 for West Texas Intermediate crude contracts, many of which are for swap dealers without physical hedging positions.

This excessive speculation is a significant factor in the price Americans are paying for gasoline, diesel and all energy products. Even the executives of the major U.S. oil companies recognize this.

On April 1, 2008, in testimony for the Select Committee on Global Warming, Mr. John Lowe, Executive Vice President of ConocoPhillips said, "It is likely that the large inflow of capital into the commodity funds is temporarily exaggerating upward oil price movements."

At the same hearing, Mr. Peter Robertson, Vice Chairman of Chevron noted a "flight to commodities" adding that an economist was quoted in *The Wall Street Journal* saying: "Crude futures prices have decoupled from the forces controlling the underlying physical flows of the commodity."

In the testimony of Mr. Robert A. Malone, Chairman and President of BP America, he pointed to a "growing interest among financial investors in oil and other commodities."

And at a May 21, 2008, Senate Judiciary Committee hearing, Shell President John Hofmeister agreed that the price of crude oil has been inflated, saying that the proper range for oil prices should be "somewhere between $35 and $65 a barrel."

In May 2008, the International Monetary Fund (IMF), compared crude oil, over the past 30 years, to the price of gold. Gold prices are not dependent on supply and demand, and have been viewed as a highly speculative commodity. The IMF analysis shows that crude oil prices track increases in gold prices.

What this means is that oil has been transformed from an energy source into a financial asset, like gold, where much of the buying and selling is driven by speculators instead of producers and consumers. Oil has morphed from a commodity into a financial asset, traded for its speculative value instead of its energy value.

Even the Saudi Oil Minister has argued that high oil prices are due to excessive speculation in the markets.

As former Secretary of Labor Robert Reich noted on National Public Radio a few weeks ago, the problem is the government's failure to curb excessive speculation.

The Commodity Exchange Act recognizes the dangers of excessive speculation. Section 4a of the Act 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 derivatives transaction execution facilities **causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce.**" (emphasis added) As a result, Section 4a provides the CFTC with the authority to set position limits or take other actions necessary to curb excessive speculation.

However, there are significant loopholes that exempt energy trading from these protections against excessive speculation: the Enron Loophole, the Foreign Boards of Trade Loophole, the Swaps Loophole, and the *Bona Fide* Hedging Exemption. While the recently passed Farm bill addressed the Enron Loophole for electronic trading facilities here in the United States, a significant portion of the energy trading continues to be exempt from any CFTC action to curb excessive speculation.

My bill, the 2008 Prevent the Unfair Manipulation of Prices Act (H.R. 6330), would end these exemptions, to ensure that excessive speculation is not driving these markets beyond supply and demand fundamentals.

The 2008 PUMP Act, the most comprehensive energy speculation bill in Congress, would address:

- **Bilateral Trades:** These trades are made between two individuals and are not negotiated on a trading market. Because the farm bill only closed the Enron Loophole for trades on electronic exchanges, these bilateral trades remain in the dark.

  The PUMP Act would require that these bilateral trades are also subject to CFTC oversight.

- **Foreign Boards of Trade:** Petroleum contracts offered through the IntercontinentalExchange (ICE) on ICE Futures are cleared on a foreign board of trade in London. On average, more than 60 percent of traders on ICE Futures are located in the United States. They're trading West Texas Crude, with a delivery point in the United States. That's a foreign board of trade in name only.

  Recently, ICE Futures agreed to provide the CFTC with trader information and to set position limits for their traders. However, this step is not enough. ICE still has a revised "No Action" letter, meaning that beyond information sharing and position limits, CFTC still won't have any authority to enforce U.S. laws.

In addition, NYMEX is in the process of offering U.S. traders access to the exchange in Dubai, raising similar questions for that market.

To clarify CFTC's jurisdiction over these "foreign" boards of trade, the 2008 PUMP Act would give the CFTC authority over these exchanges if they are using computer terminals in the United States, or they are trading energy commodities that provide for a delivery point in the United States.

- **Swaps Loophole:** Swaps are currently excluded from requirements for position limits to prevent excessive speculation. Today, 85 percent of the futures purchases tied to commodity index speculation come through swap dealers.

  Because there are no requirements for position limits, these swaps have grown exponentially, driving crude oil prices higher. By eliminating this exemption, swaps would be subject to position limits to prevent excessive speculation.

- ***Bona Fide* Hedging Exemption:** The Commodity Exchange Act allows exemptions from position limits for businesses "to hedge their legitimate anticipated business needs."

  However, in 1991, CFTC authorized the first "*bona fide* hedging" exemption to a swap dealer (J. Aron and Company, which is owned by Goldman Sachs) with no physical commodity exposure, and therefore, no legitimate anticipated business need.

  Since 1991, 15 different investment banks have taken advantage of this exemption, even though they do not have a legitimate anticipated business need.

  The 2008 PUMP Act would clarify that "legitimate anticipated business needs" does not mean energy speculators.

- **Strong aggregate position limits:** Once all of these loopholes are closed, we can then take effective steps to curb excessive speculation.

  My bill would require the CFTC to set aggregate position limits on energy contracts for a trader over all markets. Especially with the growing number of markets, speculators can currently comply with exchange specific position limits on several exchanges, while still holding an excessive number of total contracts in the aggregate.

  By setting strong aggregate position limits over all markets, CFTC would be able to curb excessive speculation by making sure traders aren't amassing huge positions in a commodity in an attempt to play one exchange off of another.

By closing all of these loopholes and setting strong aggregate position limits, CFTC would be better able to monitor trades to prevent market manipulation and help eliminate the unreasonable inflation of energy prices caused by excessive speculation, helping to protect American consumers.

The 2008 PUMP Act has 60 bipartisan cosponsors, and has been endorsed by several agriculture, airline, labor, and industry groups, including the National Farmers Union, the Air Transport Association, the International Brotherhood of Teamsters, and the Industrial Energy Consumers of America, which is a coalition of more than 35 different companies such as Dow Corning, Goodyear, BASF, U.S. Steel, Tyson Foods, and International Paper, amongst others. The full list of groups endorsing the 2008 PUMP Act is listed on the endorsement letter that I have included with my testimony. I have also included a section by section description of the 2008 PUMP Act.

I understand that there is literally a "War Room" that has been created by those on Wall Street who would like to continue to see energy trading remain in the dark. I'm sure they're hiring a lot of lobbyists and making every attempt they can to discredit those who are calling for reform.

However, I urge the Members of this Committee and my colleagues in the House to look at the evidence for themselves. We can either continue with the *status quo*, and excessive energy speculation can continue to inflate energy prices beyond underlying supply and demand fundamentals. Or, we can stand up for our constituents, who facing high prices at the pump, and our nation's businesses, who are struggling to cope with a weak economy and high production and transportation costs due to energy prices.

Excessive speculation is having a devastating effect on energy prices, causing significant hardship for our entire economy. I look forward to working with Chairman Peterson and the Members of the Agriculture Committee to send legislation to the President's desk to address excessive speculation in energy markets, to offer consumers some relief at the pump.

ATTACHMENT I

**Section 1**

Short Title: "Prevent Unfair Manipulation of Prices Act of 2008"

**Section 2**

*Energy Commodities No Longer Exempt from CFTC Oversight*

- Eliminates the current exemption from CFTC regulation for over-the-counter energy commodities by amending the definition of an exempt commodity to no longer include energy.
- Defines an "Energy Commodity" to include: coal, crude oil, gasoline, diesel fuel, jet fuel, heating oil, propane, electricity, and natural gas.
- Stipulates that if an energy transaction provides for a delivery point in the United States or is traded on a computer terminal located in the United States, it is subject to the rules that regulated markets (NYMEX) are already subject to, including large trader reporting, record-keeping, and prohibitions against fraud and market manipulation.
- This applies to: designated contract markets, energy trading facilities here in the U.S., bilateral trades, and trades transacted on a foreign board of trade.

*Extension of Regulatory Authority to Swaps Involving Energy Transactions; Section 2(g) of the Commodity Exchange Act (CEA):*

- Closes the swaps loophole, no longer allowing energy transactions to be excluded from the requirements of the Commodity Exchange Act. This would require the CFTC to provide greater oversight over these swap transactions.

*Extension of Regulatory Authority to Energy Transactions on Foreign Boards of Trade; Section 4 of CEA:*

- Requires that traders of energy commodities on a foreign board of trade be subject to the rules that regulated markets are already subject to if they are using computer terminals in the United States or they are trading energy commodities that provide for a delivery point in the United States.
- Requires the CFTC to notify Congress and allow public comment on any energy transaction that it intends to exempt from regulation in the future.
- Nullifies all previously issued "No Action" letters for foreign boards of trade for energy transactions and provides 180 days for exchanges to comply.

*Requirement to Establish Uniform Position Limits on Energy Commodities; Section 4a(a):*

- Requires the CFTC to set aggregate position limits on energy contracts for a trader over all markets. Especially with the growing number of markets, speculators can currently comply with exchange specific position limits on several exchanges while still holding an excessive number of total contracts in the aggregate. By setting aggregate position limits over all markets, CFTC would be better able to make sure traders aren't amassing huge positions in a commodity in an attempt to play one exchange off of another.

*Swaps No Longer Eligible for Exemption as **Bona Fide** Hedging for Energy Transactions; Section 4a(c) of CEA:*

- Closes the *bona fide* hedging exemption for energy swaps not backed by a physical commodity. A growing number of speculators have taken advantage of the *bona fide* hedging exemption to avoid position limits and other CFTC action to limit excessive speculation. While 4a(c) provides an exemption from position limits for *bona fide* hedging to allow businesses "to hedge their legitimate anticipated business needs", speculators have exploited this provision, even though their trading is speculative and, not for the legitimate business needs of a user or producer.

*Special Rules Applicable to Bilateral Included Energy Transactions; Section 4(a) of the CEA:*

- Requires reporting and record-keeping by bilateral traders. This will allow CFTC to monitor for fraud and manipulation.

*Public Disclosure of Index Funds; Section 8 of the CEA:*

- Requires CFTC to make public information on the size of positions invested in commodity index replication strategies and disclose the total value of energy contracts traded by commodity index speculators.

*No Effect on FERC Authority; Section 2 of CEA:*

- Protects the Federal Energy Regulatory Commission's (FERC) authority provided in the 2005 Energy Policy Act to prosecute market manipulation in natural gas and electricity markets.

**Section 3**

*FERC Cease and Desist Authority; Section 20 of the Natural Gas Act, Section 314 of the Federal Power Act:*

- Provides FERC with Cease and Desist Authority to freeze the assets of companies prosecuted under the anti-manipulation authority given to FERC in the 2005 Energy Policy Act. FERC is currently unable to freeze the assets of violators. As a result, by the time FERC is ready to assess penalties, the company could have liquidated and distributed their assets, allowing them to avoid any monetary penalties. This legislation will allow FERC to freeze these assets to ensure that once a company is found guilty of manipulating natural gas or electricity markets, the agency can secure a full recovery on behalf of consumers and taxpayers.

ATTACHMENT II

June 20, 2008
Hon. BART STUPAK,
Chairman,
Subcommittee on Oversight and Investigation,
Committee on Energy and Commerce,
U.S. House of Representatives,
Washington, D.C.

Dear Mr. Chairman:

Ten days ago, a broad coalition of consumer, labor, and business organizations joined to advocate immediate reforms in the widely-speculative energy commodity futures markets. While a long-term, rational energy policy including increased supply is our ultimate goal, bipartisan, near-term solutions to the market frenzy are absolutely critical. Experts agree that today's surging oil prices are beyond those warranted by supply-demand fundamentals and are due, in large part, to rampant speculation.

In early June, speculators traded more than 1.9 billion barrels of crude oil—22 times the size of the physical oil market, including $150 billion traded on the New York Mercantile Exchange alone. Sophisticated "paper" speculators who never intend to use oil are driving up costs for consumers and making huge profits with little to no risk.

With your leadership, we see an end to the current unwarranted escalation in oil prices. All coalition members are pleased to endorse and to pledge our full support for the prompt enactment of your proposed "Prevent Unfair Manipulation of Prices Act of 2008." The PUMP Act will apply a much needed brake on rampant energy commodity speculation to drive down unprecedented, surging oil prices crippling the economy.

The heart of PUMP is Section 2 that extends CFTC jurisdiction over energy commodities that now enjoy a host of trading loopholes. Specifically, we applaud your bill's focus onopening up the market to greater transparency and fairness to level the playing field for all traders. We fully support the bill, including strong provisions that:

- bring over-the-counter energy commodities within CFTC's oversight responsibilities;
- close the "swaps loophole" by extending CFTC regulatory authority to swaps involving energy transactions, another important step towards needed transparency;
- extend CFTC regulatory authority to energy transactions on foreign boards of trade that provide for delivery points in the United States, a common sense measure as other products delivered in the United States are subject to the full panoply of United States regulation, save energy commodities; and
- require CFTC to set aggregate position limits on energy contracts for a trader over all markets, ensuring that traders do not corner markets by amassing huge positions and playing one exchange off another.

The undersigned strongly endorse the PUMP Act, urge Congress to act promptly, and pledge our full support for your efforts.

Air Carriers Association of America;
Air Line Pilots Association;
Airports Council International;
Air Transport Association;
Air Travelers Association;
American Association of Airport Executives;
American Society of Travel Agents;
Association of Professional Flight Attendants;
Industrial Energy Consumers of America;
International Association of Machinists;
International Brotherhood of Teamsters;
National Air Traffic Controllers Association;
National Business Travel Association;
National Farmers Union;
Regional Airline Association.

The CHAIRMAN. I thank the gentleman for his testimony.

Next we have Mr. Larson from the First District of Connecticut, Member of our leadership and somebody who has been very active as well on this issue.

Mr. Larson, welcome.

**STATEMENT OF HON. JOHN B. LARSON, A REPRESENTATIVE IN CONGRESS FROM CONNECTICUT**

Mr. LARSON. Thank you, Chairman Peterson, and Ranking Member Goodlatte, Mr. Etheridge, and Mr. Moran for your outstanding work and service, distinguished Members of the Committee for your hard work, and I think the Chairman set the appropriate antenna at the start of the hearing when talking about the complexity of this issue and yet the need for us to get it right.

And the historic position that has been played by the Agriculture Committee, especially in looking at the whole issues of commodities dating back to 1935, and the Act's inception, and the grave concerns that were laid out back then by President Roosevelt and the need for us to make sure that we looked very clearly and specifically into this issue of speculation.

You are the heirs of a great tradition and one that I think the Chairmen jointly points out that you have to make sure you are weighing all sides of the issues and arguments but in the final analysis that you get it right.

I am proud that, in the tradition of this Committee, I have introduced legislation "bipartisanly" with Mr. LoBiondo that is called the Consumer Oil Price Protection Act. There are more than 120 sponsors of this Act, and the genesis of it, I would like to take credit for it, but it comes from Main Street America. It comes from the Independent Connecticut Petroleum Association, it comes from your local gas station attendant, it comes from the diesel fuel owners, the home heating oil people, who have recognized that the whole issue of supply and demand has gone awry, something that in testimony by everyone from the former head of the CFTC to the President's EIA Commissioner, and also everyone down to the Secretary General of OPEC, indicating that speculation has played a role in this process.

Very simply, my legislation says that if you intend to participate in the currently unregulated dark market established by Section 2(g) or 2(h) of the Commodity Exchange Act, then you must be capable of either producing or taking final delivery of the product. In other words, we are taking speculators out of the dark markets and shedding light on their activities.

Speculators play an important role. They play an important role in a regulated market. Roosevelt recognized it. Your forbearer recognized it as well. What they also recognized was the need to limit

those positions in terms of making sure that those that are actually the physical hedgers, those that are in the forefront of supply and demand and making sure that a market-based system prevails with the oversight of government, be allowed to go forth. That is the premise of this legislation.

Mr. Stupak has gone into some of the statistics that—I think everybody should take notice when you see this 71 percent of the market is dominated now by speculators as opposed to physical hedgers, only account for 29 percent of that market, then something is awry.

So what is it then that I and Mr. LoBiondo and other Members are asking of this Committee and what I believe the Chairman has laid out? You are the policymakers in the final analysis. Who do commodity markets serve? The producers and the consumers of the underlying commodity or the speculators? My grandfather Nolan had a great way of saying it, "Trust everyone but cut the cards." And your responsibility is, which I don't have to inform you of, is to make sure that, not only that you cut the cards but you shuffle them. Make sure people are getting a fair deal with respect to this.

So should oil be treated as a physical commodity with a finite supply as it was before 2000, or as a financial asset as it is being treated today? That is very important for this Committee. Treat it as a commodity or a financial asset or some kind of alchemy that has happened in-between in the dark market.

What citizens in this country demand, given the complication of this issue, is straightforward answers and a Congress that will level with them about the plight that we are currently in.

This Committee, as was pointed out by several of my colleagues here, established on March the 18th of 1935, two basic principles. They said, "The fundamental purpose of the measure," that being the Commodity Exchange Act, "is to ensure fair practice and honest dealing of the commodity exchanges and to provide a measure of control over those forms of speculative activity, which too often demoralized the markets to the injury of producers and consumers and the exchanges themselves."

The bill has another objective. The restoration of the primary function of the exchanges, which is to furnish a market for the commodities themselves. I believe that President Roosevelt had it right. I believe that the Committee back then had it right. I understand the awesome responsibility and challenge that you have, and this Committee has already taken bold steps as previous speakers have already indicated.

But this is also an important step. It is not a panacea. There is no silver bullet in this, but this is in terms of the integrity of the laws of supply and demand, and I dare say the Congress in this Committee as it relates to restoring market principles, to be able as Leonard Boswell says very simply, to take delivery, makes common sense at a time when Americans are trying to conserve their cents and dollars.

Last, I would like to say that I hope the Committee takes a look within the CFTC, and I realize it is not the domain of the Committee. I have a bill currently before Henry Waxman's Committee, to establish an independent Inspector General, one that is appointed by the President, ratified by the Senate, but has inde-

pendent status on the CFTC. Not someone that is appointed by the CFTC and therefore, is under the stipulations of that person who has hired them, but someone who is truly independent. I hope the Committee takes that into consideration.

In closing, I think that the bell has rung and that the historic evidence is here for the Committee to take action. Historically it has got away. How are we going to treat this issue? Are we treating the finite supply of oil as a commodity, or are we going to allow it to be treated as a financial asset or some kind of alchemy in-between? That is a difficult choice. Your forbearer made it by limiting the positions and understanding as Mr. Stupak has alluded to in his legislation and as others, Ms. DeLauro, Mr. Van Hollen, to limit that position so that we can provide a more democratic process and allow the Main Street participants to more fully participate in the benefits of a free market system.

I thank you for the opportunity to speak before you today.

[The prepared statement of Mr. Larson follows:]

PREPARED STATEMENT OF HON. JOHN B. LARSON, A REPRESENTATIVE IN CONGRESS FROM CONNECTICUT

I want to thank Chairman Peterson and Ranking Member Goodlatte for myself, and for the 119 cosponsors of my legislation, H.R. 6264, which I call the Consumer Oil Price Protection Act, for holding this important hearing and providing the opportunity for me to speak here today. I'd also like to recognize and thank Congressman LoBiondo, the lead Republican cosponsor on this bipartisan legislation for his commitment to this issue.

First let me recognize the hard work of the Chairman and this Committee on the 2008 Farm Bill over the last year, which took a first step towards regulating the "dark" energy markets. It has become clear to me, however, that these provisions, first put forward over a year ago, have already been overcome by the frenzied activity in our commodity markets. More direct and expedient action is now required.

According to the American Petroleum Institute's July 1st U.S. Pump Price Update, the price of gasoline is up almost 30% from a year ago. Current prices for gasoline are at their highest levels over the last 90 years when adjusted for inflation, and June set the record for the highest modern monthly average price for gasoline. The record high for the average price of gasoline changed fifteen times in the last seventeen weeks.

My constituents, consumers and businesses alike, are desperate not just for relief—but for a fair deal. There is increasing evidence that the skyrocketing cost of a barrel of oil today, or a gallon of heating oil or gasoline at the pump no longer reflects actual consumer supply and demand for oil and gas.

A myriad patchwork of loopholes in our commodities markets that have become apparent since the enactment of the Commodity Futures Modernization Act of 2000. These loopholes plague the *perception* that the market is functioning normally *and* impede the ability for the CFTC to conduct necessary oversight and data collection across the entire market.

Today you will hear about legislation introduced by my colleagues to close and regulate the various loopholes that are commonly referred to as the 'Enron Loophole', the 'London' or 'Foreign Board of Trade' Loophole, the 'swaps loophole'. I strongly support these approaches.

However, while closing those loopholes will finally bring transparency and oversight to the markets, it will not entirely address a more fundamental issue: the level of speculative participation in the markets. Which is why my legislation takes a different approach to this problem, one that can be considered as part of a comprehensive approach to reforming these markets.

Very simply, my legislation says that if you intend to participate in the currently unregulated, or "dark" markets established by Section 2(g) or 2(h) of the Commodity Exchange Act, that you must be capable of either producing or taking final delivery of the product. In other words, we are taking the speculators out of the "dark" markets and shedding light on their activities.

This approach is based on the premise that the commodity markets, as established by the Commodity Exchange Act of 1936, exists to serve the benefit of those

dealing in the production and consumption of a physical, tangible, product with a finite supply.

My legislation grew out of the concerns of the Independent Connecticut Petroleum Association, which represents fuel oil dealers and gasoline distributors across my state, many of which are small family owned businesses. These businesses are on the front lines of this issue, facing end use consumers on one end, some of whom have to turn over their entire Social Security check to pay for heating oil, and the oil markets on the other end. They are closest on the ground to the true pulse of supply and demand in these markets, and as the price continues to skyrocket, more and more companies are having trouble increasing their credit necessary to continue deliveries to their consumers.

In 2005, I requested a GAO investigation into the CFTC and oil futures trading on NYMEX, specifically to determine the impact of the new trend of large non-commercial or institutional investors such as hedge funds speculating in the market.

This report was completed in October 2007 and concluded "in light of recent developments in derivatives markets and as part of CFTC's reauthorization process, Congress should consider further exploring whether the current regulatory structure for energy derivatives, in particular for those traded in exempt commercial markets, provides adequately for fair trading and accurate pricing of energy commodities." [1]

**The Role of Physical Hedgers *Versus* Speculators**

In properly functioning markets, speculators play an important role in managing financial risk. The danger of combining unregulated speculation with commodities that have a finite supply like oil is that it can become excessive, causing artificial price distortions and volatility in the market. New CFTC data, discussed in a hearing in the Energy and Commerce Subcommittee on Oversight and Investigations last month show that in 2000, when the CMFA was enacted, 63 percent of the oil on the WTI futures market was held by physical hedgers, compared to 37 percent held by speculators.

By April of this year, that ratio had reversed itself, with speculators now dominating 71 percent of the market compared to physical hedgers at 29 percent. This dramatic shift begs this Committee to address the philosophical questions:

> *(1) Who do the commodity markets exist to serve—The producers and consumers of the underlying commodity, or the speculators?*
>
> *(2) Should oil be treated as a physical commodity with a finite supply, as it was before 2000, or as a financial asset, as it is being treated today?*

The historical record is quite clear that the commodity markets exist for what are referred to as physical hedgers. Physical hedgers are essentially the producers and consumers of the underlying product.

Report Number 421 from the Committee on Agriculture in the 74th Congress, on the Commodity Exchange Act submitted on March 18, 1935 stated the two basic tenants behind the Commodity Exchange Act:

> (1) "the fundamental purpose of the measure is to insure fair practice and honest dealing on the commodity exchanges and *to provide a measure of control over those forms of speculative activity which too often demoralize the markets to the injury of producers and consumers and the exchanges themselves.*"
>
> (2) "The bill has another objective the restoration of the primary function of the exchanges which is *to furnish a market for the commodities themselves.*"

President Roosevelt said in his message to Congress on February 9, 1934, "It should be our *national policy* to restrict, as far as possible, the use of these exchanges for purely speculative operations." Given that since 2000 speculators have taken control of over 70 percent of the WTI futures market, *on the one exchange that is currently regulated,* we need to ask ourselves if the market has become exactly what President Roosevelt warned against.

**Market Fundamentals No Longer Apply**

There are many parallels to what is happening today in our economy between investment in the commodity markets and Congress' grappling with the activities of speculators during consideration of the Commodity Exchange Act in 1935 and 1936. This Committee recognized in its report on the Commodity Exchange Act in 1935, that "Since the passage of the Securities Exchange Act of 1934, there has been observed an increasing tendency on the part of professional speculators to transfer

[1] GAO–08–25 *Commodity Futures Trading Commission, Trends in Energy Derivatives Markets Raise Questions about CFTC's Oversight,* October 2007, p. 58.

their activities from the security markets to the commodity markets, a tendency which makes the enactment of this bill without further delay of vital importance."

A similar shift in activity and capital has become evident since large portions of the commodity markets for oil were deregulated by the CFMA of 2000. Just as the equity markets face increasing scrutiny and potential regulation from the subprime mortgage fallout, we start to see more dramatic increases in capital suddenly flowing to the oil commodity markets. Additionally actions by new institutional investors not envisioned in the 2000 CFMA reforms have emerged, including those seeking to use the commodity markets as a hedge against the falling dollar and those applying long term equity portfolio growth strategies to commodities.

The essential function of price discovery that futures markets play has become distorted in the current excessive speculative activity. As far back as 2005, Lee R. Raymond, the Chairman and CEO of Exxon Mobil said, "We are in the mode where the fundamentals of supply and demand really don't drive the price."[2] Earlier this year, Chip Hodge, a Managing director of MFC Global Investment Management's $4.5 billion energy portfolio said, "Clearly, the fundamentals don't matter at this point."[3] Guy Caruso, head of the Energy Information Agency testified to the Senate earlier this year that a speculative premium existed in the price of a barrel of oil.[4] Even Abdalla al-Badri, OPEC Secretary General was widely quoted in the press in December 2007 saying that "The market is not controlled by supply and demand . . . It is totally controlled by speculators who consider oil as a financial asset."

There seems to be general agreement between oil executives, investment managers, the Department of Energy, and consumers that the current price of oil is not entirely contributable to supply and demand.

**Supply-Side Arguments Reinforce the Need for Re-Regulating Oil Markets**

Critics of legislation targeting speculators often cite increased demand from China and India, bottlenecks in the refining process, or other supply disruptions like natural disasters for rising prices.

However, if it is limited access to supplies of oil that is increasing the price, not excessive speculation in the market, then clearly, oil is a tangible commodity with a finite supply, not an intangible financial instrument as defined by the CFMA of 2000. It should therefore minimally be subject to the same regulatory protections provided for agriculture products.

These arguments only reinforce the need for the approach taken in H.R. 6264, that the markets should operate on the needs of the underlying physical producers and consumers.

**Restoring Basic Fundamentals to the Market**

The approach H.R. 6264 takes to restore the fundamentals of supply and demand to the market and reestablish a reliable price discovery process is to focus on the activities of the physical hedgers, the producers and consumers, the market participants the commodity markets were established to serve.

Michael Masters, in his testimony before the Energy and Commerce Subcommittee on Oversight and Investigations on June 23, 2008, summed up why this is effective very succinctly:

> *"**Bona fide** physical hedgers are motivated by one thing—risk reduction. Physical commodity producers trade in order to hedge their actual physical production. Physical commodity consumers only trade in order to hedge their actual consumption. For this reason, their trades are always based on the actual supply and demand fundamentals that directly affect them in the underlying physical markets. Their trading decisions strengthen the price discovery function of the commodities futures markets."*

To accomplish this, H.R. 6264 says that if you intend to participate in the currently unregulated, or "dark" markets established by Section 2(g) or 2(h) of the Commodity Exchange Act, that you must be capable of either producing or taking final delivery of the product. In its current form, it is written against current law, and assumes that sections 2(g) and 2(h) of the CEA are not modified as proposed by Mr. Stupak in H.R. 6330 or Mr. Van Hollen in H.R. 6341. Recognizing that responsible speculation provides the liquidity necessary for the commodity markets to

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[2] *"Some Wonder if the Surging Oil Market Is Ignoring Supply and Demand"* by Simon Romero, NEW YORK TIMES, March 15, 2005.

[3] *"Crude Oil Trades Near Record $108 as Returns Outpace Equities"* by Mark Shenk, *Bloomberg.com*, March 11, 2008.

[4] Senate Energy and Natural Resources Committee Oversight Hearing: EIA's Revised Energy Outlook, March 4, 2008.

function efficiently, H.R. 6264 allows speculators to continue to participate in the existing regulated markets, where their activities can be conducted in the light of day and are fully disclosed, and subject to position limits and other oversight measures followed by regulated exchanges. By limiting the participation of speculators and focusing on the activities of the physical hedgers this legislation will ensure that prices will most accurately reflect the true supply and demand of the underlying physical commodity.

Even if provisions of H.R. 6330 or H.R. 6341 are adopted that would change the current structure of Sections 2(g) or 2(h) of the CEA, this Committee will still need to look at solutions to address or determine the limits defining excessive speculation in the market. H.R. 6264 is adaptable to those changes. For example, one approach suggested by Michael Masters in his recent testimony would be to allow the physical commodity producers and consumers to determine what level of speculation, and thereby liquidity, is necessary for the proper functioning of their market.[5]

**Establish an Independent Inspector General at the CFTC**

As Congress seeks to implement reforms of the oil commodity markets, it is imperative that the CFTC have an independent Inspector General office to ensure that the directives issued by Congress are implemented and adhered to by the CFTC. The current Inspector General sits under the office of the Chairman of the CFTC, who also hires the agency's IG. This relationship makes the IG dependent on the Chairman. However, an Inspector General appointed under Section 3 of the Inspector General Act of 1978 would be chosen by the President and confirmed by the Senate. They maintain an independent office. I have recently introduced legislation, H.R. 6406 that would establish an independent Inspector General's office at CFTC. While this legislation has been referred to the Government Reform Committee, it is nevertheless relevant to this discussion and important to this Committee's deliberations.

**Closing**

This Committee must determine whether the underlying purpose of the Commodity Exchange Act is to provide a market for the commodities themselves and some control over speculative activities, or whether the markets exist purely for the use of speculators.

The historical record to me is clear: commodity markets exist to match buyers and sellers of physical commodities, with finite supplies, with consumers or end-users. The data that continues to come forward in Congressional hearings and now even from the CFTC is clear. The ratios of speculative activities to physical activities in these markets are skewed. A mechanism must be set to determine or limit speculative positions across all markets and reduce the role noncommercial investors, who cannot and do not accept delivery of the physical product.

H.R. 6264 provides a pathway to accomplish that. Together this bill and the proposals put forward by my colleagues today provide a framework for a comprehensive solution. I stand ready to work with you to craft the best possible policy to address the changes in the commodity markets that have evolved over the last several years.

I thank the Chairman and Ranking Member for their consideration of these views, and would be happy to answer any questions.

The CHAIRMAN. I thank the gentleman very much for his testimony, and we have enough time to get Mr. Welch in before we have to vote. I want to remind all the Members of the panel if you want to make sure your legislation has a good chance of getting passed or incorporated, that you come back and engage in a dialogue with us as we try to move through this, but I understand people are pulled different ways, but we would appreciate coming back.

So we will hear Mr. Welch and then we will come back as soon as the votes are over.

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[5] Michael Masters, Managing Member/Portfolio Manager, Masters Capital Management, LLC, Testimony before the House Committee on Energy and Commerce Subcommittee on Oversight and Investigations, June 23, 2008.

**STATEMENT OF HON. PETER WELCH, A REPRESENTATIVE IN CONGRESS FROM VERMONT**

Mr. WELCH. Thank you, Mr. Chairman, Mr. Goodlatte. Thank you, Committee Members. I really appreciate the opportunity to be here, and I will be brief with votes coming up.

I introduced a bill on November 1, 2007, to close the Enron Loophole, and basically the question that this Committee has to provide guidance to the full Congress on is number one, should we regulate? Should we regulate the energy future markets?

The 109th Congress came to a conclusion that we should not, and they passed into law the Enron Loophole that took away any regulatory oversight of those exchanges. This Congress with the leadership of this Committee, came to a different conclusion and said, we should regulate. And you passed regulatory provisions that started closing the Enron Loophole in the farm bill, and I thank you for that.

The second question is, does speculation have adverse consequences? It has been stated by many, and it is well known by the Members of this Committee more than any others in Congress that it serves a very constructive function. But what we do know is that there are historic examples, recent historic examples where unregulated speculation has had very damaging effects on markets and on consumers. The most vivid and current example is what happened with the Enron Loophole, and Enron used that, of course, with its Enron On-Line to drive up the price of electricity in California by 300 percent.

And all of us opposed that. So the question now is if we have made a different decision as a Congress, that there is a rule for proper, and I emphasize the word proper, and the burden is on this Committee to give us guidance on what that means, regulation or what should we do? My legislation did basically three things.

First, it said we have to have transparency in the transactions. Plain and simple. Then all market players are aware of what is going on. Second, it required that there be real time information given to the CFTC so they would be able to do their job on a timely basis.

And third, it said all traders, whether they are foreign or domestic, are subject to the same rules, and that is why many of my colleagues have introduced legislation to close the London Loophole or the Dubai Loophole. But basically it is common sense that if you have a regulatory scheme, it should apply to all who trade, whether they do it from a terminal in London, Dubai, or Washington D.C.

Now, this Committee did pass and Congress adopted your provisions on closing the Enron Loophole, but my suggestion, Mr. Chairman, is that we need to go a bit farther, and the major reservation I have about what we did pass was that in order for the CFTC to enact regulation on some of these foreign exchanges, it required the CFTC to make a specific finding on a contract-by-contract basis of a significant price discovery event.

And frankly, what that does is create an enormous regulatory and bureaucratic burden. What I believe is a better approach on regulation is to have a bottom line approach of what it is you want for information, transparency, timely disclosure, and then rules that everyone understands and can play by. And then the enforce-

ment is ferreting out when there have been violations and take an appropriate enforcement action.

So it is going to be the job, it is the job of this Committee. I really applaud you, Mr. Chairman, for asserting jurisdiction, because there is a lot of pressure out there on all of us to, "do something," and we all want to do something, but it is imperative that the something that we do helps, and doesn't hurt.

So thank you very much for allowing me to be part of this important hearing.

[The prepared statement of Mr. Welch follows:]

PREPARED STATEMENT OF HON. PETER WELCH, A REPRESENTATIVE IN CONGRESS FROM VERMONT

First, let me thank Chairman Peterson for convening this critically important hearing. I also need to thank Sean Cota, President of a great community-based fuel dealer in my State of Vermont for first bringing the issue of speculation in the fuel markets to me last fall.

Vermonters and residents of other cold-weather states are facing the equivalent of a Category 5 storm. Our constituents are on the edge, and as they look forward to the cold, winter months, many of them are afraid of what they might find—home heating bills doubled, sometimes tripled from what they were last year.

Each weekend I hear the same thing from Vermonters: increasing expenses for fuel, child care, health care, and education are making it harder and harder for working families to make ends meet. Energy costs are an enormous driver of this crisis and they are only escalating. The average U.S. heating oil bill is expected to be a record $3,500 for the upcoming winter, up 76% from two winters ago. This is not sustainable. Based on the current state of the market, speculation is a large contributing factor to the astronomical spikes we have had in just the past 12 to 18 months.

I frequently hold "Congress in Your Community" events around my state in order to hear directly from Vermonters about the issues important to them, and to see if I can offer assistance. It was a Congress in Your Community last fall in Bellows Falls where Sean Cota approached me with a story that was truly hard to believe: in 2000, the 109th Congress passed a loophole for Enron that is now inflating fuel prices for all of our constituents by an average of $800 to $1,000 a year. I then discovered that the non-partisan Government Accountability Office (GAO) had documented this consumer rip-off. A few days later, I introduced H.R. 4066, to close this egregious "Enron Loophole."

In 2000, Enron and several large energy companies successfully lobbied the Republican-led Congress to exempt energy markets from government regulation. This lack of oversight has resulted in multi-billion dollar price manipulation and excessive speculation by traders. This special interest loophole is allowing energy traders to rip off Vermonters and Americans who are already struggling every winter to heat their homes. The previous Congress sold us out to Enron, creating a Wild West in the energy markets at the public's expense. It's time to end this rip off.

The "Close the Enron Loophole" bill calls into question the excessive speculation occurring in the marketplace. Are we going to allow the oil futures market to continue to profit from ripping-off our hardworking constituents, or are we to pass and enforce responsible regulations on energy futures trades. Families, who already struggle to pay fuel bills, should not be forced to choose between putting food on the table and keeping their house warm as energy traders continue to line their pockets.

Several provisions of my bill were included in the farm bill recently signed into law. Unfortunately, it was not enough, and I believe the language was far too diluted. My bill if enacted will establish government oversight of the trading of unregulated energy commodities to prevent price manipulation and excessive speculation. The bill would give the Federal Commodity Futures Trading Commission much-needed monitoring and enforcement authority.

This legislation simply introduces oversight to the energy market. It is an overdue fix to a grossly irresponsible loophole that never should have been created.

Again, thank you Chairman Peterson for your attention and commitment to finding a solution to this problem. Speculators should not have free reign in the oil markets, reaping vast profits at the expense of American families. I am happy to answer any questions about my legislation.

The CHAIRMAN. I thank the gentleman very much. I thank all of the panel Members. I would encourage all Members to come back because immediately after the votes we will proceed to questions and come to a conclusion.

The Committee is in recess.

[Recess.]

The CHAIRMAN. The Committee will come back to order. As I expect, there are all kinds of other stuff going on, so I am not sure exactly who is going to be here how long, but we will move ahead here with whatever time we have available.

So I am going to first recognize the gentleman from North Carolina, our Subcommittee Chairman in this area, Mr. Etheridge for a short statement and question.

Mr. ETHERIDGE. Mr. Chairman, thank you, and let me thank you and the Ranking Member for holding this meeting and my partner, Jerry Moran, for being here.

I think since 2000, we all know the volume on the commodities market have increased six fold. However, during that same period of time, the staffing level for the CFTC has fallen to the lowest level in the agency's 33 year history. And there has been a growing concerning about energy trading and overseas futures market. Some worry that trading on these markets, particularly crude oil trading on the European markets, is affecting our own domestic energy markets by increasing volatility and raising prices.

As you know, today, tomorrow, and Friday, hearings will examine these issues and determine if additional Congressional action is necessary. Like many of my colleagues here, I've introduced a piece of legislation, H.R. 6334 that addresses many of these issues and will do three very specific things, others, but I will just mention them here before I get to questions. It will ensure that foreign markets are not adversely affecting our markets. My bill directs the CFTC to ensure that these markets are comparable, required to publicize the trading information, position limits, accountability levels for speculators, as do domestic markets that trade U.S. energy products. My bill will also require the CFTC to change their reporting of traders in energy markets to more clearly show what positions and how much influence these funds have in energy markets.

And finally, it would require an additional 100 full-time equivalents at the CFTC that are needed to effectively regulate the futures market, including our energy markets. And let me remind everyone that this was asked for by the Chairman of the CFTC that I think is important.

Now, let me say that no one factor is responsible for the current energy prices. So it behooves us to examine the question of excessive speculation, deliberately and thoughtfully, and these hearings will allow us to do that. That being said, let me thank my colleagues for being here today for the work they put in this for studying, and let me ask the first question to my colleague, Mr. Stupak. In reading your testimony, you mention that 117 hedge exemptions were granted since 2006 for the West Texas crude oil contracts on NYMEX, many of them for swap dealers. Your bill addresses hedge exemptions by limiting the exemptions to *bona fide* hedges and de-

nying exemptions to those seeking to hedge a swap transaction. Is that correct?

Mr. STUPAK. That is correct.

Mr. ETHERIDGE. With that, let me run a few numbers by you and get your response. On January 2, 2006, according to testimony, crude oil was trading at about $65. In January of 2007, it was still in the low $60's. The number of hedge exemptions granted for traders hedging against a swap in 2006 was 46. That is approximately 109,783 long contracts, and 113,283 short contracts were held in excess of position limits over the course of the year.

In January of 2008, oil has climbed to almost $100 representing a 54 percent increase over the course of 2007. The number of hedge exemptions granted to traders for a swap declined in 2007 to 36, and the number of contracts held in excess of position limits for the whole year also declined to approximately 94,519 long contracts, and 90,253 short contracts. Today, crude oil is about $135 to $137 which is a 35 to 37 percent increase over this year.

The number of hedge exemptions granted to traders for swaps so far in 2008 has fallen to 11, and this represents 23,804 long contracts, 23,709 short contracts so far this year. So as the price of oil has risen, use of the hedge exemption and the number of contracts given to hedge exemption has steadily declined. I raise that because since you worked in this area, I will get your answer. What does this say about your argument that swap dealers are using the hedge exemption to ramp up prices?

Mr. STUPAK. There, Mr. Chairman, because where are they settling at? The long and the short, where are they settling at? What is the price they are settling at? It is not the number of contracts that is out there, it is where are they settling.

Mr. ETHERIDGE. Yes, but if the numbers are reducing, the overall contracts and numbers, how does that indicate—cashing the exemption?

Mr. STUPAK. Look at your open interest on that one chart that I had. What was your open interest? What are they settling at when they settle? That is what it would be. I bet if you go back to 1979, when the Hunt brothers tried to take over the silver market, I bet you would find the same thing that exemptions and that given would probably settle out. What happened with the Hunt brothers? Until we cut off the exceptions that they were given, they netted out every day. The longs and short netted out each day. And therefore, the argument—the same thing was made. You have a long, you have a short. You have a short for every long. But what happened? It was $7. It went to $50. And then as soon as they told the Hunt brothers, enough is enough and we closed off that market to them, it went right back to $7. It wasn't the number of contracts, it is where does the contract settle?

Mr. ETHERIDGE. But in that case, they were actually taking possession of the silver.

Mr. STUPAK. No, they weren't. They were required to take possession of the silver. And therefore, that's when we brought it back down, the price of silver, when they tried to hoard the silver market in 1979.

The CHAIRMAN. The gentleman from Kansas.

Mr. MORAN. Mr. Chairman, thank you very much. I appreciate the opportunity we are going to have this week to consider this issue of speculation. I appreciate my colleagues from across the country and their interest in being here today and trying to highlight some legislative options that we have in regard to speculation. I also would like to associate myself with the remarks of Mr. Peterson, the Chairman, and Mr. Goodlatte, the Ranking Member, in their opening statements. Very much what they said is compatible with my thought process on this.

I am fearful that we have become confused in the difference between speculation and manipulation, and clearly we want to make certain that market manipulation is not occurring but excessive speculation, I need to understand why excessive speculation is actually something that manipulates the market.

It is interesting to me that we are having these discussions for much of the time I have been in Congress. My farmers have complained to me about speculation, those who don't have to deliver a commodity. Their complaints have been based upon the reality that commodity prices are too low. And so today we hear that speculation causes high prices. In years past and on the agricultural side, we heard numerous times about how speculators caused low prices.

This Subcommittee that Mr. Etheridge chairs that I serve as the Ranking Member has been very active in these topics, and I am pleased that we are re-engaged in this issue and continue to be engaged in this issue that now confronts us.

I guess my question would be perhaps to you, Mr. Stupak. I watched part of your Subcommittee's hearing, and the slides that you showed, and maybe this is what you were suggesting to Mr. Etheridge, the slides showed that 71 percent of the long open interest crude was held by speculators, and then the Subcommittee had another slide showing that 68 percent of the short, open interest in crude was held by speculators. So roughly 7 in 10 speculators hold long positions. Those market participants would profit if the price went up, and almost the same number, almost 7 in 10, would profit if the markets went down. Is that fact significant as we look at the relationship between increased speculation, greater speculators, greater volume of speculation in the market as compared to rising crude prices?

Mr. STUPAK. Well, as you indicated, and that is the chart right there that we had at the Subcommittee, we refined it a little bit more based upon information from the CFTC. And in January, the commercial or the hedgers controlled 63 percent of the market. Look at the movement over the last 8 years. You are down to what, 30 percent of the market. The people who are legitimately hedging, the airline industry, the trucking industry, those would have to buy their fuel to hedge against future increases are getting squeezed out of the market. And as more money flows into this market, the more they are going to get squeezed. With the swap dealers, they have almost doubled their position, and the noncommercial entities, those are those who have no interest, but they are playing in this market. Too much liquidity, too much cash, drives the market up. And that is what you are seeing right here, this trend. The trend is rather disturbing. You go from what, what did I say in my opening statement? How many contracts where you are talking

about there at one time, and now you are up to over three million? It was 114,000 to 3 million in a short period of time.

The CHAIRMAN. Will the gentleman yield?

Mr. MORAN. I yield, Mr. Chairman.

The CHAIRMAN. I don't pretend to be an expert in this but what I have been asking people is if you go into this swap market and you get a position, then they turn around and lay that risk off in the over-the-counter market. It is how it works and they net these things out, and there might be a situation where you have some small amount of long or short that you have to cover in the NYMEX and that happens at some level, whatever it is, four percent, ten percent, whatever it is. But it is a small amount, but that ends up over in the NYMEX. But the rest of this never gets into the system, I don't see how it affects anything because it is these two guys over here making this deal and whatever they settle at is not doing anything with price discovery, it is not affecting the futures market. The only part of it that is going into the marketplace that could have an effect is that difference that they have to go in and lay off in the NYMEX or wherever they are doing it, or the ICE.

Mr. STUPAK. And CFTC has been using this argument, long and shorts, they come in very close, there is very little difference as you indicated, basically a net zero. But what they are not telling you is when the buyer and seller, when they settle, when they cross, what is the price?

The CHAIRMAN. What difference does it make because it is not being used for price discovery?

Mr. STUPAK. Because that contract is then sold and it is at a higher floor than what it was before. You don't know where it settled.

The CHAIRMAN. So this is affecting the spot market?

Mr. STUPAK. Second, Mr. Chairman, you indicated yourself you don't know where the over-the-counter trades are going on. You are only seeing part of the picture. That is why transparency is so important.

The CHAIRMAN. If the gentleman would yield, I would agree that we need to know what is going on here. I don't think many of us disagree with that, but I am still trying to understand, if you go out there and make this thing—some of these people are never buying oil.

Mr. STUPAK. True.

The CHAIRMAN. So you have these index funds—so that that money goes some place. I guess it is in some Wall Street account or something. Then they go and hedge this with some other bank. But this never buys and oil, it never goes onto the NYMEX to have any affect. So what I am trying to get at is nobody can tell me and draw a line to show how this is working. It sounds like something devious, but I am a CPA and I need to follow the money and understand how this works and I still can't track this. It doesn't seem like this is having an affect on price discovery.

Now, you may not like the fact that these people are doing this, and that is kind of a different issue. I am not sure pension funds should be in the commodity market at all given the volatility of it.

So I just would like somebody to explain to me if these things never get over on the market, how they are affecting the price.

Mr. STUPAK. But when you take the hedge fund exceptions, they only cover the last 3 days of that trading. When you do a contract, you hold it and it is the last 3 days that are most critical. What happened the first 27 days, you have no idea. So there is a lot of movement in this market. If I don't hold mine for the 27th day, I sell mine on the 25th day, you have no idea what I did——

The CHAIRMAN. I understand that.

Mr. STUPAK. You don't know what the cash settlement——

The CHAIRMAN. The money is not going into the market, it is going into Goldman Sachs or whoever has this deal.

Mr. STUPAK. Correct.

The CHAIRMAN. So what is it doing, affecting the price of their stock? I don't see how it affects the futures market if it doesn't go into the futures market. I mean, if somebody could explain that to me, it would make this job easier. I don't see how——

Mr. STUPAK. We don't know a lot of it because as you have indicated yourself, Mr. Chairman, half of it is on the over-the-counter trading, the ICE market, the Dubai market. We don't know what is going on in those markets. We don't have any idea what is going on, but we know that they are selling West Texas crude. We know the Enron loophole for the London market, 64 percent of the WTI, West Texas Intermediate, had been traded on that market which is running up that price of that crude. And the cash settlement, when you come to settle out, there is no substitute for oil. So you are stuck at that price. Even the spot market looks to the market, the NYMEX, for their price.

The CHAIRMAN. The gentleman from Virginia. I think you had some questions in this area.

Mr. GOODLATTE. Yes, I do. I wanted to follow up on the questions that the gentleman from North Carolina was asking about, the hedging that the gentleman from Michigan mentioned in his testimony.

Mr. Stupak, in your testimony you said that physical hedgers represent a smaller and smaller portion of the market and offer this as proof that increased speculation yields higher prices. However, we will hear testimony tomorrow from Dr. Jim Newsome who is the CEO of the New York Mercantile Exchange that data analysis indicates that the percentage of open interest held by speculators relative to commercial participants actually decreased over the last year, even at the same time that prices were increasing.

He further states in his testimony that noncommercial long and shorts, in other words speculators, consistently have been in the range of 30 to 35 percent of the open interest. This would mean that hedgers make up the balance or 65 to 70 percent of the market. That is much different than the 29 percent that you cite in your testimony. And so I guess my question is how are we, the Committee of jurisdiction on this issue, supposed to interpret the disparities between the claims made by you and others and the data provided to us by the exchange that knows exactly what positions are on their exchange?

Mr. STUPAK. I would suggest you ask the gentleman if the noncommercial leaves out the swaps. The answer is noncommercial

trades leave out the swaps. That is where you can see here on our chart, April 2008. We broke it out so you could see your noncommercial and you could also see the swaps. So I would ask them that question, does noncommercial include swaps or not?

Mr. GOODLATTE. Okay. I will ask him that. Let me ask you this. In addition to this data, Dr. Newsome will testify that noncommercials, speculators, are relatively balanced between being long and being short, and that has already been mentioned already by some of the others here. How do we reconcile that data with your testimony and some of the things we are seeing in the media?

Mr. STUPAK. The issue isn't how many are long, how many are short to get to a net position. Again, as I have tried to indicate, since there is a long for every short and a short for every long, the net positions don't tell you what price the buyer and seller actually crossed at. What is that floor that is being established? You don't know that. You know the number of contracts. Only on NYMEX, only on NYMEX. You don't know the number of contracts, long and short, on ICE. You don't know the number of contract on Dubai. And when you take a look at it, the experts we consulted with pointed out that the chart that the CFTC will show you tomorrow takes in all the contracts that could be for every month which takes in all months and lump them all together. And in the information that we have been providing you have been 30 day looksees. When you put all 9 years' worth and then you close it out, you can't pinpoint anything by lumping all these months together. The good news is the CFTC is going to ask these swap dealers for their information, and I look forward to seeing that data when it comes in.

But remember, go back to silver, the Hunt brothers. Every day they had long and short. There was a zero there.

Mr. GOODLATTE. But remember, the Hunt brothers controlled a significant amount of the supply of silver, and we don't have that situation here with the type of speculators that you are talking about.

Mr. STUPAK. Well, if you see with the noncommercials and the swaps are controlling 70 percent of the market, I think that is a significant part of the market. The hedgers are only down to 30 percent. That is just like the Hunt brothers all over. Instead of calling them swaps and noncommercials, let us call them the Hunt brothers. They have moved from 30 percent of the market——

Mr. GOODLATTE. But I don't think——

Mr. STUPAK.—and now it is 70——

Mr. GOODLATTE. I don't think they own anything. I don't think they control the supply. And on that point——

Mr. STUPAK. They have these contracts, don't they?

Mr. GOODLATTE. Let me——

Mr. STUPAK. And there are only so many contracts given, right?

Mr. GOODLATTE. They don't control the supply of oil the way the Hunt brothers controlled the supply of silver. But let me ask you this on that very point.

Mr. STUPAK. Go ahead.

Mr. GOODLATTE. You and some others have cited hedge exemptions as a way for parties to increase their speculative positions. The CFTC has now made data available to us that allows us to

analyze this. In 2006, for swap agreements, 19 firms requested hedge exemptions. Thus far in 2008, only four firms have requested hedge exemptions. For combination hedge and swap agreements, 23 firms requested hedge exemptions in 2006. In 2008, thus far only eight firms have requested hedge exemptions.

During the time that crude oil had a large run-up in price, the request for hedge exemptions have fallen significantly. How do we reconcile that data with what we have been hearing here today?

Mr. STUPAK. If I have one of these exemptions, if I have my hedge exemption, and I said there are 117 of them, right, there is no need for me to go back next year to get another exemption from the CFTC because I already have it.

Mr. GOODLATTE. Why didn't it happen a lot sooner then?

Mr. STUPAK. Why didn't it?

Mr. GOODLATTE. Yes.

Mr. STUPAK. The first one started in 1991. It was J. Enron which is——

Mr. GOODLATTE. Well, I know——

Mr. STUPAK.—Goldman Sachs.

Mr. GOODLATTE. The price increases in oil which are a concern to all of us right now——

Mr. STUPAK. Sure.

Mr. GOODLATTE.—and we want to get to the bottom of it and if you or others are right, we certainly want to make sure that there is all the transparency in this market so that there isn't an artificial inflation here. But assuming that your observation is correct, and we will again ask our witnesses tomorrow about that, but assuming it is correct, why didn't it happen sooner than now, this year, the last few months? Why does it all of a sudden spike up now when these exemptions have been granted over a long period of time and very few of them are being additionally granted now? Presumably if this were the avenue toward creating the bubble you talk about, you would think there would be more people in there saying, "Hey, I missed the boat, I want that exemption now."

Mr. STUPAK. Well, I guess you would almost have to ask them, but as my testimony indicated, NYMEX granted 117 hedging exemptions since 2006 just for West Texas crude, 117 in less than 2 years for West Texas crude. Remember, these exemptions are usually permanent over the last 3 days of the contract.

Mr. GOODLATTE. Thank you. We will ask those questions of our witnesses tomorrow. Thank you, Mr. Chairman.

The CHAIRMAN. Are there any other Members that have questions along this line? Mr. Conaway?

Mr. CONAWAY. Thank you, Mr. Chairman, and I was excited to hear almost every one of the witnesses say they wanted to do everything possible to address these high prices. I am excited about the opportunity to address supply issues in maybe a different forum.

If there is a huge premium in the market, why is this Fadel Gheit—has his firm shorted this market? In other words, if there is this giant bubble in there that we think is about to burst, have they shorted it and it was sold out? These guys are the professionals, the pros, that don't take delivery of crude oil. They are

making money going both directions, so why are we not seeing a lot of pressure on the short side?

Mr. STUPAK. I guess you would have to ask him.

Mr. CONAWAY. Yes, we will.

Mr. STUPAK. Oppenheimer, you know.

Mr. CONAWAY. Yes.

Mr. STUPAK. That is who he is with.

Mr. CONAWAY. But I mean, you testified, you used his testimony to support your position.

Mr. STUPAK. Yes.

Mr. CONAWAY. And I am just saying, did you ask him that? If he is so firm on his position his conviction, has he actually shorted the market?

Mr. STUPAK. I did not ask him that question.

Mr. CONAWAY. Okay. Mr. Van Hollen, you mentioned a zero speculative premium. How would we know that?

Mr. VAN HOLLEN. I am sorry?

Mr. CONAWAY. You mentioned that you wanted to wring out all the speculative premium and get it to zero. How would we ever know that?

Mr. VAN HOLLEN. What I said was I thought that the changes that we are suggesting through this legislation in terms of greater transparency in the markets, both with the London loophole as well as other actions we could take, would help squeeze out what I believe is a speculative premium. And again——

Mr. CONAWAY. But you mentioned getting to zero in your testimony, and I was just curious——

Mr. VAN HOLLEN. No, what——

Mr. CONAWAY.—how would we know?

Mr. VAN HOLLEN. What I said was, there have been different testimonies given before different Committees as to exactly what the speculative premium is. All I was suggesting was based on all the testimony I have heard, I think it is above zero. I don't know what it is. Some people have said it is 50 percent, some people have said it is $30 per barrel. I think what I was saying was based on the testimony I have heard, it is above zero. The CFTC, as you know, has stated that it is in perfect balance, that their testimony so far I believe before Congress has been that there is no speculative component, that the price of oil is being set by the force of supply and demand. I just think that there is enough testimony out there to suggest that there is some premium there, and what we are proposing here are some different ways to get at it by giving the CFTC greater regulatory authority.

If I might just quickly, because I know Dr. Newsome is going to be testifying before this Committee, he testified earlier, as you know, before the Congress, and I know you are going to get to the FBOT, the London loophole issue, but his testimony before this Congress was with respect to ICE, "It was not anticipated that the no action process would be used in this manner which has effectively diminished the transparency to the CFTC of approximately ⅓ of the West Texas Intermediate crude oil market and permitted an easy avenue to circumvent position limits designed to prevent excessive speculation." So the purpose of this legislation is to begin to get at some of these things which, according to Dr. Newsome

and other experts, have created some speculation premium. I don't know what it is, but what I was saying is I think it is greater than zero.

Mr. GOODLATTE. Will the gentleman yield?

Mr. CONAWAY. Yes, but I do have one more question.

Mr. GOODLATTE. I just wanted to make a note in the record on the issue that we have been discussing on hedge funds and hedge exemptions, we have here a report from the CFTC regarding the figures that I just cited. There are two types of hedge exemptions. One is an annual exemption valid for 1 year, and one is a temporary exemption valid for one trade. There are no permanent hedge exemptions to our knowledge. The four that I cited in 2008, three were temporary, in other words for one trade, and one was an annual exemption. Thank you, Mr. Chairman.

Mr. VAN HOLLEN. Mr. Chairman, I am sorry. I don't know if you are keeping track of time or if this is more——

The CHAIRMAN. Well, we are in free flow here.

Mr. VAN HOLLEN. Unfortunately——

The CHAIRMAN. So I recognize the gentleman from Maryland.

Mr. VAN HOLLEN. Thank you, because unfortunately, I have a 4:30 meeting that I have to be at. I just want to mention one other thing in connection with the conversation with Mr. Stupak. Regardless of how much money at the end of the day is a result of swaps is going into the futures market, it seems to me there is also a legitimate question about whether or not when you have index funds making those investments in the futures market, whether they should get these hedge exemptions. As you know, you or I can go buy Goldman Sachs index funds, and Goldman Sachs can then go hedge that risk. They go into the futures market, and there is no reason that my investment in Goldman Sachs via their transfer into the futures should be treated as a hedger. I am a speculator. I am using this as an investment vehicle. And the fact of the matter is, there has been testimony, even from the CFTC, that that is an opaque area that they can't figure out and they have been granting these exceptions as if every dollar going in is a hedger. And that is just not the case.

So I just want to make that point. Unfortunately, I have to——

The CHAIRMAN. Yes, I understand that and that information is now being acquired as I understand it by the CFTC, and this has been one of the things we have discussed with them. They are acquiring it. I talked to them yesterday, and the information is coming in. Initially they were going to have this ready by the 15th of September. I told them I thought that was too late. And so they are moving this along as fast as they can, but we are apparently going to get that information, hopefully. But these index funds, from what I can understand, money is being put in there by a pension fund or whoever it is. They get some kind of an investment back, a piece of paper, I don't know what it is, that money never buys any oil. And generally, the money doesn't go into the futures market. What happens is whatever that position is, they go over-the-counter and hedge it with some bank or whoever will take the risk on the other side. No oil is ever bought. The only time this ever has any impact on price discovery or the futures market is when there is a difference that they can't lay off over-the-counter

and net out, and then they will go over to the futures market and then it will be—it is in there and we can see what it is.

So again, my question is that if this money is never going in there, and if it is not being used for price discovery, and they are over here doing whatever they are doing, I think somebody is going to lose a lot of money at some point. But that is not what this Committee's business is about. We are trying to make sure the futures markets are not being manipulated, and nobody is cornering the market on anything and so forth. So we are kind of getting mixed up. It is like these securitized mortgages that they trenched and sold to people. Somebody should have been watching that. There is no way they should have ever let them do that. But that is a different issue.

Ms. DELAURO. But Mr. Chairman, if I might for a second. It may be a different issue except it is a part of what I said in my comments. This is a fact. We dealt with the lack of oversight, the lack of regulation, as it had to do with the subprime market. We have an agency which is coming before my Committee tomorrow, it is going to come up before this Committee tomorrow. Where were they, where have they been, what are they doing? They are charged with addressing this issue of potential manipulation or excessive speculation. And it was only recently, within the last few weeks, that they decided that they would need to have additional reports, additional transparency. This is not just the last couple of weeks. This is an agency that in fact has been in my view, and we are going to ask them the questions about this, they have been asleep at the switch while this is going on, and who pays the price.

The CHAIRMAN. Well——

Ms. DELAURO. It is the ordinary person. It is the ordinary individual who is getting killed out there with this.

The CHAIRMAN. Well, I wouldn't disagree that they have been behind the curve on this, okay, and that we probably should have had more information. But in their judgment and what the testimony has been is that they are saying that they don't think that this swap situation is affecting the prices and so forth, and maybe they are wrong. And this is what we are trying to figure out here, but you have just as many people saying that this is not running up the prices as you have saying that it is. And that is what we are trying to get to the bottom of here.

Ms. DELAURO. I understand, Mr. Chairman, except I would say, I don't know, I am not going to make a calculation of how many are saying that there is and how many not. I don't have a balance here, but there seems to be a predominance of information that this has some bearing.

I will make this comment, and I hope it is not offensive to some folks is that these are agencies that are charged with addressing a serious crisis. The fact of the matter is, and I believe the right decision was made, that people spent day in and day out Treasury and others, looking at what was going on with Bear Stearns. And they said, "We have to act quickly because we are going to see the financial markets collapse." So they worked day in and day out, overnight, behind closed doors, and they addressed the issue and came up with a solution. Whether you agree with it or not, I think they had to do what they had to do.

We now have a very serious situation, very serious for consumers. We are now just saying, well, it is the market, this is the volatility of the market, that is that. And the agencies charged with addressing this issue again in my view are not doing their job in terms of sitting down and getting to the answers that we are talking about. I for one, and I said in my opening comments, I am not an economist, I am not an academic in this area. I look to the agencies that we charge with the responsibility to address these issues, and they have fallen short and they quite frankly pick and choose the areas in which they are going to bring relief in the marketplace.

Mr. CONAWAY. Mr. Chairman——

The CHAIRMAN. I thank the gentlelady.

Mr. STUPAK. Mr. Conaway, could I——

Mr. CONAWAY. I just have one more question and that is back in June 23rd——

Mr. STUPAK. Right.

Mr. CONAWAY.—there was a report in response to maybe your bill, Bart, I don't know, but the issue of American imperialism, in other words, the extra-territorial use of American laws will have a backlash among the folks in London and Dubai and other places where they think they may do a pretty good job of regulating. Would you address your attitude toward their responses on us telling them how to regulate their markets?

Mr. STUPAK. Sure. First, you asked about Mr. Gheit, Fadel Gheit, if he sold short, I pulled his testimony. He is the Managing Director and Senior Oil Analyst so he is not in the commodities so he wouldn't have been selling short or long.

Mr. CONAWAY. He works for a firm that does that all day long.

Mr. STUPAK. Right. But not him. I thought you meant him personally.

Mr. CONAWAY. Oh, heavens no. He doesn't make that much money.

Mr. STUPAK. So you have to check with him. For the London loophole, the ICE market, we have given our enforcement powers to London for an exchange that has its headquarters in Atlanta, has its trading engines in Chicago, Atlanta, which does, some estimate, 30 percent West Texas crude sold in here. They sell contracts that says for delivery in Cushing, Oklahoma, and they use terminals here in the United States. But because we have this No Action letter given by the CFTC, we rely upon London to enforce the laws because we say London laws are similar to ours. I respectfully say they are not.

For instance, London does not require position limits or accountability levels to prevent excessive speculation or market manipulation. That is allowed in London and the same as Dubai. Unlike the CFTC, the FSA, Financial Services Authority, does not publish a Commitment of Traders Report which provides a public accounting of long and short futures positions held by large traders, plus there is far less transparency under the FSA regime. The FSA does not provide comparable emergency powers—to suspend trading or increase margins.

So why would we outsource our enforcement in this field that affects all of us so much? Why don't we put the cop back on the beat here in the United States?

Ms. DELAURO. Would the gentleman yield?

Mr. STUPAK. Sure.

Ms. DELAURO. I just would add to the issue of the No Action letters, I think it is imperative to find out and it is one of the things I am going to try to ascertain in our hearing is I understand the current process to CFTC staff has issued these No Action letters. I have a series of questions that I am interested in. Who broadly defined requests in No Action letters? Who reviewed or effected the content and the timing of the No Action letters within CFTC and elsewhere? What legal and policy rationale was used to justify the letters? And why, given the enormous consequences and the controversial nature that the full Commission does not formally review and approve them? Or who is accountable for the issuance of these letters? And as my colleague, Mr. Stupak said, we are off-shoring, if you will, authority in these areas which doesn't seem to make sense.

It is very, very interesting that with regard to some of these efforts, the primary financial beneficiaries are Goldman Sachs and Morgan Stanley. I also think that it is also important to note that their representatives, sit on the CFTC's Energy Advisory Committee. I think one has to take a look at that. Is this in fact a conflict of interest? How do we have two of the principal beneficiaries in this area who sit on one of the four or five committees that are the underpinnings of the Commission. You understand that these are serious questions, you want to get to the bottom of it as we do. And what we are trying to do is to propose legislation where we think we can bring back the issue of home-based enforcement before, as was the case before 2000.

Mr. LARSON. Will the gentlelady yield? To that point, Mr. Chairman, I do think that especially given the legislation that this Committee has already put forward and to the gentlelady's questions, and questions that were being developed by Mr. Stupak, that it does seem entirely logical that we would have an independent Inspector General within the CFTC. We currently do not. And in your considerations, I hope you will take that under advisement as I know the gentlelady will as her Committee looks at this and the importance of making sure—you know, there is a tendency to feel like Eddy Murphy in *Trading Places* here when you are talking about swaps and hedging and series. And I think Mr. Chairman, you have said this before that it takes a while to get your arms around all this stuff and demystify it for the general public. And yet, that is our responsibility and in part, this Committee's responsibility in the long run. It sure would help if you had an independent source appointed by the President, confirmed by the Senate, that you knew was assisting in looking out for the American consumer.

The CHAIRMAN. I thank the gentleman. The gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman. I think we have some 31 different pieces of legislation that have been introduced in order to try to address this problem. It may be more than that. The CRS

report that covers this issue lists 31. I am one of them. I have a piece of legislation that is similar to Mr. Etheridge's that also provides for more independence for the auditor, Inspector General, within the CFTC.

I think it is important for all of us to put into context the sort of heat that has been exchanged here. We are all interested in seeing lower prices for our consumers. There is nobody here that isn't interested in that. We all appreciate the extent to which people are suffering. Ordinary folks are suffering with this. It is certainly the case in a district like mine which is very rural, and people are very dependent upon gas prices. Just to get to work is a challenge for people, diesel and gas the way it is right now.

And so we are all in the same boat. We are all trying to figure out what the problem is here and what can be done about it. Virtually everybody who has testified before this Committee, including virtually every expert I have talked to, acknowledges that a large part of the problem is the weak dollar. Estimates range from 25 percent to more. So let us not lose sight of that. We have a weak dollar policy at the moment. The weak dollar is part of the problem here.

Everybody also concedes that there are market fundamentals that are involved in this, that worldwide demand has caught up with the world's ability to provide supply. Everybody concedes that. So let us not lose sight of that as we talk about what has been referred to here as "excessive speculation."

And the final thing that we don't want to lose sight of, and many people don't want to hear this, is expert after expert after expert will tell us that if we overstep, if we make a mistake in the process of trying to address this issue, we will wind up pushing these markets to places where they will be less opaque and less regulated. They will have the same kind of impact on us because we are stuck with the world commodity market; that is every single expert virtually without exception.

Now, obviously there are things we can do. Many of us have suggested that. We are trying to figure out what it is, and what I keep hearing today is excessive speculation, excessive speculation. I would like to explore that with some questions, if I could.

The way the futures markets have evolved, and it is not just oil, it is all commodities, we initially were just looking to give people who were in business an opportunity to hedge risks, one way or the other. And it was difficult to pull them together. It was difficult to find somebody who was interested in buying that commodity that somebody wanted to make sure they could sell at some point in the future and *vice versa.*

The way the markets evolve is actually over a period of time in a process that invited what you might call speculators to come in and provide liquidity to take opposite positions. It was something that was very important to commercial entities. They had to have that, and all responsible commercial entities recognized that. So we have traders today in these markets who never take delivery, they are basically playing the market, whatever you want to call it. They are making their financial bets but they are providing liquidity which makes available to hedges that are important to commer-

cial ventures, and it also lessens the cost associated with getting your hedge. That is also very important to these commercial folks.

So I am unsure. We are not talking about that as being excessive speculation. This is the sort of thing that is just part of the market. DRW, Inc., in Chicago, for example, its net delta is always zero, and it probably provides more liquidity for the oil market than any trader in the world.

Now, we weren't talking about excessive speculation 2 or 3 years ago. We are talking about it now. I don't think there was any legislation in the hopper to deal with excessive speculation 2 or 3 years ago. So something has happened in the last 2 or 3 years that sort of jumped up and has gotten our attention. I have to believe it is the recent interest by pension funds, sovereign wealth funds, and others in taking positions in the commodity markets. And so I guess my question is to my fellow Members here who are struggling just like I am trying to figure out a way to fix this for our folks; that is what excessive speculation is. Is anybody here suggesting we should not let pension funds or ordinary folks who otherwise wouldn't have access to the commodity markets or buying commodities, we ought not let them to have access to buying commodities to take positions where commodities are concerned?

Mr. STUPAK. I don't think anyone is saying that. Two years ago some of us were concerned about the excessive money and liquidity coming into the market. That is when I first did the PUMP Act, looking at certain aspects of it was 2005, 2006 when I introduced the legislation. There has to be some liquidity in the market. Speculators can and do play a role for significant price discovery, but when you go from a $13 billion to $260 billion at the blink of an eye, there is too much in there. It is driving up these prices.

If Congress does nothing, this market was already determined to become a foreign board of trade. Ask Mr. Newsome when he comes tomorrow when he is helping to set up the Dubai exchange, NYMEX. The regulated market can't beat ICE, the IntercontinentalExchange, so they might as well become them. So they are setting up this Dubai market and they will be asking for a No Action letter. So in other words, this market is moving more and more in the dark, not more transparency but less transparency.

Mr. MARSHALL. I hate to interrupt my baseball buddy——

Mr. STUPAK. Sure.

Mr. MARSHALL.—but you are just a witness here. You are a fellow Member, but you are a witness so I get to interrupt you.

Mr. STUPAK. Okay.

Mr. MARSHALL. Would you get back to what excessive speculation is so I can understand that? Tell me how I figure out what speculation is and——

Mr. STUPAK. Well, go back to your definition——

Mr. MARSHALL.—what speculation is not.

Mr. STUPAK.—Section 4(a) of the Commodity Exchange Act that I had in my testimony where they set forth what it means. And in a nutshell, when the market has a detrimental impact to your national economy as energy has right now, I hope we, as responsible legislators and good baseball players, will go take the bat to this

and bring some control to this market because we are really hurting this whole economy——

Mr. MARSHALL. Mr. Stupak——

Mr. STUPAK.—causing sudden or unreasonable fluctuations of unwarranted changes in the price of such commodities is an undue and unnecessary burden on interstate commerce.

Mr. MARSHALL. Every one of us agrees. We are just trying to figure out what it is that is causing this to occur and how to stop the thing that is causing it. So are you saying figure out how not to let pension funds get involved in this or sovereign wealth funds or——

Mr. STUPAK. Why would a pension fund want a *bona fide* hedging exemption? They are not interested in oil, the Chairman said many times. Why does Harvard invest their endowment funds in the commodities market? Are they interested in taking control of any wheat, any corn, any oil?

Mr. MARSHALL. Would——

Mr. STUPAK. But they use this exception——

Mr. MARSHALL. May I interrupt? Would we prohibit hedge funds from—what you are talking about is the hedge exemption is being used in order to permit money flowing into Goldman Sachs, Morgan Stanley——

Mr. STUPAK. Yes, I'm Harvard. I go to Goldman Sachs and I say, "Yes, I got this $2 billion——

Mr. MARSHALL. I got that, but would you prohibit these folks from investing directly in the futures market?

Mr. STUPAK. No. No.

Mr. MARSHALL. Taking long——

Mr. STUPAK. But how about some position limits? I can play one exchange off the other. When Dubai gets their exchange, if I ever did my position, I can play one exchange off the other, NYMEX, Dubai, ICE, and take my aggregate position and I can influence a market, especially one as small as——

Mr. MARSHALL. Would it be position limits for each of the individual pension funds or the individuals who hold interest in those pension funds? How would that work?

Mr. STUPAK. Who is doing the hedging? Is it Goldman Sachs commodity index fund or is it really Harvard? It is really Goldman Sachs.

Mr. MARSHALL. So if——

Mr. STUPAK. So Goldman Sachs should only be allowed to hold so much, right? So much position on NYMEX, so much position on ICE, so much position on Dubai. But take the aggregate, not the individual, not the individual. Take the aggregate of what they are holding. On NYMEX, it is supposed to be 20,000 contracts. Go look at it. You know how they enforce it? They call you up and say, "Hey, Jim, you got too many. Dump a little."

Ms. DELAURO. You will recall with Enron and what happened with the pension funds, pension funds ought to be able to invest but also we have an obligation to make sure that there is some regulation around so that unlike the people at the top who took their pension and ran, a whole lot of folks at the bottom lost their pension and who is there with a safety net for them? I will just say to you that I think we are looking at similarities in what is hap-

pening, and this is not just one place, it is in a variety of places, and they should invest but I believe we have the obligation to make sure that they don't go belly-up and the people who rely on them don't go belly-up.

Mr. MARSHALL. And I think the question concerning whether or not pension funds should be permitted to invest in things like this is a separate one from the question, what is the impact on the futures market, on the prices of commodities caused by all of these investors seemingly interested in getting into commodities and buying commodities.

Mr. Matheson, you have sat here patiently——

Mr. MATHESON. Sure. Mr. Marshall, I appreciate the question. The Commodity Exchange Act has a definition of "excessive speculation." My concern is not specifically excessive speculation. My concern is the potential for market manipulation based on the loophole on foreign exchanges where the CFTC isn't getting the data, and we are not holding U.S.-based traders to the same limitations that they are subject to today trading on NYMEX for example.

So I think we do have over many years developed a process in this country. We have gotten comfortable about some of the boundaries we have developed for trading here in the U.S., and technology has taken us to a new place where now we have these new challenges. We are trying to figure out how we can adjust with those technological changes. I don't think you should limit people from being able to trade in the market. I don't think you can have too much liquidity in the market. I think liquidity is good. It creates greater price discovery and reduces margins. So I don't think we should be limiting who can trade in the market beyond the position limits for individuals that already exist on NYMEX now.

I have to offer one other thought on this that points out a little bit of the confusion in this debate this discussion has been taking place right now. We have been bouncing around between futures and swaps like they are the same thing and they are not.

Mr. MARSHALL. They are not.

Mr. MATHESON. And we have to be real careful as we parse these issues out that we address them in their appropriate way. Different pieces of legislation look at these from different angles. Quite frankly, my legislation only focuses on futures, it only focuses on trading on foreign exchanges and creating the transparency and disclosure of information, and the same position limits, and the same CFTC regulations that exist today for U.S. traders. And I think that it is probably an effort to try to get more information and not in an overt way that may drive business offshore. I think when you start trying to get into the over-the-counter market and the swap market, we have to be very, very careful because if we take action that creates undue burdens on that marketplace here in this country, based on technology today, this is today, this isn't 20, 30, 40 yeas ago, those servers can move offshore like that. And the business will still take place, and as you suggested in your opening statement, you will have a more opaque situation. You will have less certainty on what is going on, and that is the challenge for this Committee, to figure out how to address this issue.

So for me, it is not a question of is there excessive speculation, the question is, is there market manipulation and does our regu-

lator, the CFTC, have the capability with the information given to it and the tools at its disposal to assess whether that market manipulation is happening; and I still think that is the overall goal that this Congress ought to be looking at.

Ms. DELAURO. Mr. Marshall, could I just use the CFTC's definition on "excessive speculation?" When the market price for a given commodity no longer accurately reflects the forces of supply and demand. This is their definition, and that is in essence what they are charged with policing under the Commodity Exchange Act.

So I think we are not making up the definitions and the terminology. The terminology exists within the mission, if you will, of the agency that is charged with——

Mr. MARSHALL. And I am aware of the definition. I am trying to figure out where is the excessive speculation in this kind of setting? What is actually causing this problem? We acknowledge that the problem has other aspects to it.

Ms. DELAURO. Exactly.

Mr. MARSHALL. It is hard to argue about that.

Ms. DELAURO. Right.

Mr. MARSHALL. So can we put our finger——

Ms. DELAURO. Well, my hope would be——

Mr. MARSHALL.—exactly what it is—if I could, Ms. DeLauro?

Ms. DELAURO. Sure.

Mr. MARSHALL. The CFTC, though I don't have the impression that they have an ax to grind here. I had the impression they are sincere, they are very informed, and they came before this Committee 2 weeks ago, the Chief Economist and the Chief of Enforcement, enormously experienced individuals. They said as far as they can tell, they can't find that the price is being manipulated inappropriately or that some sort of inappropriate forces in the form of excess speculation are causing this problem. That is what they said.

Ms. DELAURO. Well, I——

Mr. MARSHALL. I may be wrong——

Ms. DELAURO. No, but it may be that I believe that that is what we have to be overseeing in our oversight capacity. This is the agency that is charged with figuring that out. I want the best and the brightest as I know you do and other Members of this Committee do to be able to pinpoint what the difficulties are here. They are charged with that, and I don't know if it is the current set of people, well-meaning and sincere, informed, and they can't get to the bottom of this, then we need to find folks who can. I don't have an ax to grind with them, either. I, like you, want answers to the issue because we have to come to some sort of a conclusion. Not a conclusion, we have to come to some understanding so that we can apply some potential solutions to it.

Mr. MARSHALL. Mr. Chairman——

The CHAIRMAN. The gentleman from Iowa.

Mr. KING. Thank you, Mr. Chairman. I want to thank all the witnesses, too. This is a long afternoon for Members to sit in one place, and I particularly appreciate Mr. Marshall's questioning line. It covered a lot of the questions that had arisen as I listened to your testimony, so I will try to focus this down to a couple of things

and perhaps leave a minute or two for some of my colleagues who are still waiting patiently as well.

A number of things go through my mind. As Mr. Marshall mentioned, the weak dollar and global demand. I would point out with global demand, I have a sheet here from Reuters that shows that Chinese imports of gasoline this year are up 2,000 percent. So there is a global demand piece. We are looking at how to get out of excessive speculation, and Mr. Van Hollen says he doesn't know how much it is but he wants to wring it out, wants to wring the margins out that are excessive speculation. I am watching the focus of all the brain power you have put on this, and it is not just this year when gas got real high but it is an accumulation of effort over a period of time. And you know, I have turned my focus to drilling in ANWR, the Outer Continental Shelf, BLM land, more coal, more nuclear, more ethanol, more wind, more biodiesel, all of these alternatives that we have because I am a great believer of supply and demand. I hear you talk about supply and demand, but I am not convinced you all believe that supply and demand, at least in the core of this free market economy, should drive this and should set this price. Ms. DeLauro, you mentioned about excessive effects of speculation that upset supply and demand. And so do you all believe that the markets are set by supply and demand and all these commodities we are talking about? Does anybody disagree with that?

Mr. STUPAK. I think this should be the basis for it. I think we have lost that. When you see 119 percent from 2003 to now——

Mr. KING. Okay.

Mr. STUPAK.—and $13 billion to $260 billion, it is not supply and demand that is putting forth——

Mr. KING. I recognize that from your testimony, Mr. Stupak, and I appreciate that, but do we really believe? Does the panel believe that, and I guess what really caught my attention is—well, I will put it back this way and dig back through those 1,057 pages of Adam Smith's *Wealth of Nations*, not the one from Washington, the one that published that in 1776. And he was watching the price of gold at the time in the world, and gold was high. And he made the point that gold got a lot cheaper in the world because the price of everything is the sum total of the cost of the capital and the labor, that they had figured out how to take a lot of the labor costs out of gold by importing it from the New World which really was stealing it from the Native Americans, we recognize. But he showed how the gold prices had plummeted. And I look at your testimony and it says gold prices are not dependent upon supply and demand. I just have a little trouble getting past that to get to the next point, and I would ask you if you could support that statement a little more.

Mr. STUPAK. Sure. The IMF, if you take a look at it if you want to put that back up there, Scott, when was the last time we had a problem with oil? It was 1981, right? Look what happened to gold. It has nothing to do with oil, but look what happened to gold. It really spiked. So did oil. That is the last time we saw it up that high, and it has tracked perfect. Gold made in the New World in 1776, maybe we could take out the labor costs but now with this global economy, gold is basically not a supply and demand, it is a

purely speculative, high-priced metal as you indicated. And therefore, you don't see a supply and demand. But why is oil tracking it?

Mr. KING. Mr. Stupak, I heard you say that before but I still don't understand your answer. How is gold independent from supply and demand? Who demands gold? I mean, are you submitting that it isn't utilized in a way that there is a demand for it because I am thinking not only just for the jewelry but the industrial uses we have for gold. So I would say yes, that there is a demand out there and there is a supply.

Mr. STUPAK. What is gold used as? When is it hoarded? It is hoarded as a financial asset, sort of hedging against future problems within our economies, as it is right now. Well, isn't that sort of the same thing oil is doing?

Mr. KING. It is used as well for industrial purposes and also for jewelry purpose. I mean, there is a functional use for that. I didn't want to get into that particular debate, I would just point out that you have to believe in supply and demand or not. Ms. DeLauro?

Ms. DELAURO. Well, I wanted to address the issue of supply and demand from not my perspective but from a small business owner in Connecticut who will come to testify tomorrow. His name is Tom Devine of Devine Brothers. He is a full-service biofuel heating fuel dealer. These are direct quotes. I am not in this business, he is. There are two quotes. "We are no longer confident that the markets are doing their job of providing our industry and consumers with a benchmark for pricing product that is based on economic dynamics of supply and demand, and they no longer function as a risk-management tool." On the issue of supply and demand, he says, "My customers often ask, are you guys running out of product?" The answer is no. There is no supply shortage. There is no sudden upside demand shock. Simply put, we and our customers are being forced to ride the speculative roller coaster in the futures market. It is about time someone put some of the breaks on this runaway train and brought the markets back to reality. This is someone who is in the business. It is not me, and he is talking about supply and demand. What were are telling him——

Mr. KING. If I might, Ms. DeLauro——

Ms. DELAURO.—is that the markets are fine, working properly, and we are doing everything that we can and that is not the fact of life for this man.

Mr. KING. Then just to make my concluding point and that is you have convinced me that you don't believe in supply and demand the way I believe in supply and demand. I think the approach to solving this problem then is going to be different than those of us who believe strongly in supply and demand. But I thank you for your testimony and I yield back to the Chairman.

The CHAIRMAN. I thank the gentleman. The gentlelady from Ohio.

Mrs. SCHMIDT. This is very quick. Whatever we do to answer the energy crisis, we have to do with complete understanding of the picture; and from what I am gathering today, from what I am trying to learn and glean on my own is that we really don't have a total answer of this speculative role. My husband is in the financial business, and I ask him all the time, are the speculators driving

up the price? And I talk to him about what the CFTC mentioned 2 weeks ago in this Committee. And he said, "There are so many other things out there that you can't quantify. One is emotion, one is the attitude of the speculators that are in the market. If they perceive a Congress that isn't going to do anything, then they are going to drive up the price." But he also cautioned me with this. He said, "You can close the London loophole but you will just drive it further offshore. People that are in the business of making money will find ways to make money. If you take water, and we know that water tracks generally downstream, and you change it from one side of the street, it will go to the other side of the street. If we limit Goldman Sachs in their portfolio to go into this market, they are only going to create a subset of Goldman Sachs in order to accomplish it."

I, like you, want to stop the speculation. I, like you, believe that speculators have a role in this. I can't say that publicly because I can't prove it, but I have a feeling that if it walks like a duck and talks like a duck, it's probably a duck. And all I want to know is how are we going to find out exactly what is going on so that we can move whatever portion of your bill or another person's bill that is out there into the right place so we don't end up making a bigger problem than already exists.

Mr. LARSON. Make them take delivery.

Mrs. SCHMIDT. Well, but you can't do that because they will go offshore.

Mr. LARSON. Why can't you?

Mrs. SCHMIDT. Because they will——

Mr. LARSON. How will it go offshore?

Mrs. SCHMIDT. Because financial——

Mr. LARSON. If you allow for the physical hedger to deal with this as the market was intended to do, then by limiting the positions as Mr. Stupak and others have said, that you find yourself in the situation where now all of a sudden the true price becomes established; and look, I believe there is a role for speculators in the marketplace as well, but why not, as the dealer that Rosa DeLauro just mentioned and Main Street consumers and come to me, gas station guys, truckers, are they all wrong? You know, I said it before jokingly, but it is true. You feel like Eddie Murphy in the *Trading Places* where you know, we are swapping this, we are hedging this. At Augie and Ray's, they want to know whether or not their government is going to level with them about what is going on with respect to that.

Mrs. SCHMIDT. And I——

The CHAIRMAN. The gentlelady——

Mrs. SCHMIDT. What we want to do is find the bottom line of this and really what is going on in the marketplace.

Mr. LARSON. But your instincts are right.

Mrs. SCHMIDT. And I don't have the complete answer.

The CHAIRMAN. I thank the gentlelady. We have to get over and vote, and I get the sense that Members are kind of wrapped up here, so we appreciate the panel. I would just have one closing comment. This Congress made it illegal to have a futures market in onions in 1958. That is still the law. The most volatile, the big-

gest increase of any commodity in the United States, is in onions. Just as a word of caution.

Mr. STUPAK. That will bring us all to tears.

[Whereupon, at 5:30 p.m., the Committee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED STATEMENT OF HON. BARON P. HILL, A REPRESENTATIVE IN CONGRESS FROM INDIANA

Good Morning. First off, I would like to thank Chairman Peterson and the rest of the Members of the Committee for their hard work in studying the impact speculators are having on gasoline prices in the United States. I appreciate the opportunity to present the Committee with information about the bill I recently introduced, H.R. 6372, the Commodity Futures Restoration Act, which addresses the lack of transparency in U.S. commodity futures markets.

The rapid increase in gasoline prices here at home is having a profound impact on all Americans. This year the average cost of gasoline rose to $4 a gallon for the first time in history. When I return home to Indiana, the central issue on the mind of my constituents is how their families and businesses are suffering due to rising fuel costs. I am sure my colleagues have had similar discussions back home as well. I introduced this piece of legislation because I believe providing oversight to the U.S. commodities markets is the most surefire way to lower gas prices for American citizens.

Let me be clear; I do not believe reigning in excessive speculation will solve our nation's energy crisis in the long term. Yet, after meeting and hearing testimony from investors on Wall Street, oil company CEO's, and economists, it is clear to me that supply and demand fundamentals cannot fully account for the extreme rise in gasoline prices. Instead, I believe the lack of oversight of the commodities markets coupled with incredible growth of institutional investors is artificially raising the price of gasoline for American consumers.

Since 2000, energy commodity trading has been systematically deregulated and new loopholes have been created that have fostered excessive speculation in U.S. commodity futures markets. As a result, the CFTC's ability to detect market manipulation is currently being hurt by critical information gaps that exist because many traders are exempt from CFTC reporting requirements. Over the last 5 years, commodity-index investing has increased by 183%. Economists estimate excessive speculation is adding between $20 to $50 to the price of a barrel of oil. Reform is needed to prevent a price bubble similar to the one that caused the subprime housing crisis.

The bill that I introduced would simply restore the standards that were in place prior to 2000 by closing the three harmful loopholes that have destabilized the U.S. commodity markets. H.R. 6372 would make the following changes:

1. **Close the "Enron Loophole":** The Commodity Futures Modernization Act of 2000 (CFMA) exempted energy commodities traded on electronic exchanges from regulation by the Commodity Futures Trading Commission (CFTC). My bill would ensure CFTC oversight by reestablishing the CFTC's jurisdiction over energy commodities and require the CFTC to regulate energy commodities just as agricultural commodities are currently regulated.

2. **Close the "Foreign Board of Trade/London Loophole":** This loophole currently allows U.S. exchanges that are trading U.S.-delivered energy commodities to be regulated by foreign entities. As a result, the reporting data gathered from these transactions is often insufficient and leaves American consumers inadequately protected from fraud and manipulation. My bill would require exchanges that trade U.S.-delivered futures contracts, or ones that significantly impact market prices, to register with the CFTC. Put simply, markets trading U.S. commodities would no longer be regulated by overseas entities.

3. **Close the "Swaps Loophole":** As of today, banks can hedge their investors' positions without facing any position limits. The swaps loophole permits institutional investors, who have no regard for supply and demand fundamentals in the physical commodity markets, to use banks to trade without facing position limits. This is commonly referred to as the "Swaps Loophole" because it has allowed unlimited speculation in the commodities markets. My bill would reestablish the original purpose of the Commodity Exchange Act which only allowed purchasers, sellers, and legitimate users of commodities to hedge on the market.

Additionally, H.R. 6372 requires the CFTC issue a progress report within 90 on its ability to impose position limits on energy futures commodities and its capacity to implement changes set forth in the bill. The bill ensures the Federal Energy Regulatory Commission and Federal Trade Commission maintains authority over natural gas oversight and market manipulation respectively. The bill would take effect 6 months after date of enactment to provide investors and the CFTC sufficient time to make the necessary changes.

I recognize many individuals have savings invested in the commodity markets, which is why I believe it is so important this Congress carefully considers the potential impact of any market reform. This Committee's decision to hold hearings on the

various pieces of legislation is an important step to ensure we get this issue right. Our economy cannot suffer through another crash like the one we saw after the .COM and housing booms. My bill would stabilize U.S. commodity markets before our economy suffers another financial shock. This will benefit all investors in the long term, and provide the most immediate relief to ease the pain of consumers at the pump in the short term.

I believe in free market principles, but without open accounting of who is trading what, the U.S. commodity markets cannot function properly. My bill would provide the necessary changes to calm the instability in the markets and reestablish oversight to ensure that prices on the futures market reflect the laws of supply and demand rather than manipulative practices or excessive speculation. Hundreds of billions of investment dollars enter the futures markets. If no action is taken, gas and food prices will continue to rise.

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SUBMITTED LETTER BY BART STUPAK, A REPRESENTATIVE IN CONGRESS FROM MICHIGAN

July 10, 2008

Hon. COLLIN C. PETERSON,
*Chairman,*
Committee on Agriculture,
U.S. House of Representatives,
Washington, D.C.;

Hon. BOB GOODLATTE,
*Ranking Minority Member,*
Committee on Agriculture,
U.S. House of Representatives,
Washington, D.C.

Dear Chairman Peterson and Ranking Member Goodlatte:

Thank you for the opportunity to testify on July 9, 2008, before the Agriculture Committee regarding reforms to the Commodity Exchange Act to prevent excessive speculation.

I am writing to respond to questions raised at this hearing concerning the impact of 117 hedging exemptions on NYMEX. In particular, Members asked me to explain how the 48 exemptions granted to swap dealers and the 44 exemptions granted to those with combined swap/hedge positions could be relevant to rising oil prices, when the number of NYMEX-issued exemptions has decreased each year between 2006 and 2008. Since this data was marked business confidential by the CFTC, I did not have it with me at the hearing and was unable to review it in responding to your questions.

With respect to hedge exemptions for crude oil futures, the NYMEX sets a 3,000 contract position limit for the 3 days prior to settlement. NYMEX sets "accountability levels" of 10,000 contracts for 1 month and 20,000 contracts for all months outside of that 3 day window (20,000 contracts equals 20 million barrels of oil, or roughly 1 day of U.S. demand). However, unlike speculative position limits for agricultural futures, accountability levels are not hard position limits.[1]

The purpose of my raising questions about the 48 exemptions granted by NYMEX to noncommercial speculators was to question whether this is justified and valid in the sea of various loopholes. However, there are many causes of excessive speculation at this time, and I do not want to leave the impression that these 117 exemptions explain the price increase in oil by itself.

For example, these NYMEX position limits do not apply to futures positions tied to commodity index investments. Indexers close out their current month positions between the 5th and 9th day of the month, and then roll these position over into the next month—long before the position limits in the last 3 days ever kick in. As a result, indexers do not encounter NYMEX position limits.

Since the futures market serves as a price discovery market every day of the month, not just in the last 3 days prior to settlement, it is unclear why CFTC does not require that speculative position limits be set across the entire month.

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[1] According to CFTC data, there were nine entities with positions in excess of 20,000 crude oil contracts on June 6, 2008 (six had long positions totaling 198,547 contracts, and three had short positions totaling 87,753 contracts). This CITC data does not disclose whether these are commercial or non commercial speculative positions.

To remedy this problem, we recommend that legislation require CFTC to establish speculative position limits for all energy commodities, aggregate all positions and extend these across all markets (designated contract markets, exempt commercial markets, foreign boards of trade operating in this country, swaps, and the over-the-counter markets.) Hedge exemptions need to be limited to those with commercial interests in the commodity, and the practice of allowing such exemptions to non-commercial participants such as passive index speculators and their swap dealers should be ended.

Please feel free to contact me if you have any further questions.

Sincerely,

Hon. BART STUPAK,
Member of Congress.

Cc:

Hon. BOB ETHERIDGE, *Chairman,* Subcommittee on General Farm Commodities and Risk Management,

Hon. JERRY MORAN, *Ranking Minority Member,* Subcommittee on General Farm Commodities and Risk Management; and

Agriculture Committee Members.

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SUBMITTED STATEMENT OF AMERICAN SOYBEAN ASSOCIATION

The American Soybean Association (ASA) appreciates the opportunity to provide comments on the futures markets issues before the Committee. ASA is the policy advocate and collective voice of soybean producers on domestic and international issues of importance to all U.S. soybean farmers.

We support and believe that futures markets exist for the dual purposes of price discovery and risk management. The main concerns for everyone involved with using and/or regulating the commodity futures markets should be accurate price discovery for commodities and functional tools for price risk management. Many commodities are at historically high price levels. That does not mean these prices may not be accurate. We should not artificially hold down commodity prices nor should we try to artificially inflate prices or allow the markets to be manipulated. The current supply and demand situation, along with other market factors, such as institutional investments and the value of our dollar, should be considered when determining if the commodity markets are performing accurate price discovery. Caution and foresight are needed in view of our current agricultural commodity futures and cash markets. Legislation or other regulations affecting the agricultural markets must enhance price discovery and risk management for farmers.

Soybean producers, like producers of other commodities, are concerned about changes in the way futures markets are operating and their impact on risk management needs. Increased price volatility, substantially higher margin requirements, lack of cash and futures price convergence, and the influence of billions of dollars of index fund investments have greatly altered traditional farmer hedge strategies. For example, many lenders and elevators no longer offer forward contracts more than 60 days out. When the ability to forward contract soybeans for delivery in deferred months was lost, it became clear that traditional risk management strategies were no longer available. The margin requirements for grain elevators and farmers using futures contracts to reduce price risk are so large they create a financial burden. Funds normally used for general operations or to buy inventory and supplies are consumed by margin calls. Lenders have been forced to extend more credit than normal so elevators and farmers can conduct their regular business transactions. This creates more financial risk for everyone involved.

For the last 40 years, markets have operated in generally predictable ways: Chief among these was that futures and cash market prices would more or less converge at the end of a contract. The assumption that cash and futures prices for the same commodity tend to move in the same direction, during the same time period, and to approximately the same extent, has stood the test of time. Now, we see this assumption is not necessarily true. Lack of convergence, combined with high prices and, for some commodities, the absence of a cash market, have led to lack of confidence that accurate price discovery is taking place. Now lenders look at the lack

of convergence and say they cannot accurately measure the collateral value of a hedge in the futures market.

The unpredictability of convergence between the futures and cash markets makes hedging an unreliable pricing tool. All of these factors create a marketplace that severely limits farmers' abilities to manage price risk.

Of course, there have been changes in the market that we support. Higher prices and more participants in the market work to the farmer's advantage. As we look toward 2009, we know we will continue to see increases in input costs. That makes the need to have effective and predictable risk management tools even more important. The challenge for producers, Congress, and the CFTC is to ensure that markets offer a way for all participants to share risk. It is not acceptable to expect individual producers to take futures positions in a market environment where the risk and capital requirements are so high that even large multinational grain companies don't want to participate.

ASA expects the CFTC to continue open discussion of these issues with all interested parties and to take judicious action to restore confidence in the futures market. It is the CFTC's responsibility to ensure the markets provide accurate price discovery and hedging opportunities for farmers.

ASA previously offered the following short-term recommendations to the CFTC and we were pleased to see the Commission adopt many of them:

- We agree with the CFTC's decision to delay revision of speculative position limits. As we stated in our December 2007 comments on this subject, "If the changes could exacerbate lack of convergence, ASA would be opposed to increasing the limits." We reiterate our request that the CFTC analyze whether increasing speculative position limits would negatively affect convergence of cash and futures markets, and not proceed with the increase if it is determined that such increases would have negative effects.
- We second the many calls for a moratorium on new hedge exemptions, as well as a moratorium on expansion of the hedge exemptions already approved. While markets are in such flux, and while questions persist about whether index funds are legitimate hedgers, placing a moratorium on further hedge exemptions is the only reasonable course.
- We support the request of the National Grain and Feed Association (NGFA) for more detailed reporting in the Commitments of Traders report.
- We are greatly concerned that the extensive divergence in the cotton futures/cash market in March that crippled the industry could happen in soybeans and the other markets. We strongly support an investigation into activities in the cotton market during that time period.
- We agree that food producers and other market participants need to work together, rather than relying on more regulation. We encourage the CFTC's leadership in facilitating that dialogue, and recommend the Agricultural Advisory Committee as the forum where that dialogue can continue.
- We support analysis of whether the addition of more delivery points would aid futures and cash price convergence, as well as analysis of other changes in delivery terms that would positively impact convergence.
- We encourage the CFTC to analyze and then educate market users about the potential impacts of clearing of ag swaps by the CME, as well as cash settlement contracts. Producers have little information about these tools and their potential impacts.
- Above all, we strongly encourage the CFTC to work expeditiously with producers, the exchanges, and other market participants to develop solutions and tools that allow traditional hedgers to have greater confidence in futures markets.

ASA appreciates the oversight of Congress on these issues. The CFTC's role and responsibility should be to ensure the integrity of futures markets and to provide the price discovery and risk management functions needed by producers. We look forward to continuing a productive relationship with other market stakeholders that leads to renewed confidence in the market and marketing opportunities for all farmers.

SUBMITTED STATEMENT OF COBANK

**Introduction: CoBank and Agricultural Lending**

CoBank is a $59.2 billion cooperative bank that provides financing to rural cooperatives and critical lifeline businesses—food, agribusiness, water, electricity and communications—across the United States. Part of the $197 billion U.S. Farm Credit System, the bank also finances U.S. agricultural exports. CoBank is owned by its U.S. customer-owners, approximately 2,200 agricultural cooperatives, rural communications, energy and water systems, Farm Credit associations, and other businesses serving rural America. CoBank is governed by a 16 member Board of Directors, the majority of which is elected by our customer-owners. CoBank returned $245 million in patronage refunds to its cooperative owners and paid $97 million in Federal income taxes in 2007.

We are pleased to have the opportunity to comment on the challenges that the unprecedented developments in the commodity markets are posing for country elevators* and other grain merchandisers, as well as the agricultural lenders on which they depend.

The issue of credit availability is of vital importance not only for these businesses, but also for our agricultural economy and the entire U.S. economy. We concur with a number of industry stakeholders that a prudent and fiscally responsible official credit enhancement program could ease the financial stress that rising commodity prices are imposing on country elevators so that these businesses that are of critical importance to our nation's food security and economic well-being can continue to operate successfully.

**The Impact of Rising Commodity Prices on Country Elevators**

Country elevators play a vital role in the U.S. economy. Cooperative and privately owned country elevators provide essential services that allow farmers the ability to capitalize on market opportunities by serving as an important intermediary between producers and end-users. Country elevators provide farmers with storage, transportation, and the ability to retain ownership of harvested crops until they can be efficiently sold into the marketplace. The system of country elevators in the U.S. has functioned successfully for many decades and has assured fair and competitive pricing to farmers as well as access to growing international markets that otherwise would be unavailable.

Many country elevators are experiencing financial stress as the result of rising and volatile commodity prices. This stress stems primarily from the dramatic increase in the volume of funds required for the "hedging programs" that country elevators have traditionally used to mitigate price risk for farmers. Farmers traditionally have been able to lock in a price for their crop by selling their future production to country elevators through what is known as a "forward contract." Country elevators, in turn, protect themselves from the risk that prices may fall before the crop is delivered to them by the farmer by "hedging" on an exchange such as the Chicago Board of Trade or Minneapolis Grain Exchange via "futures contracts." A futures contract essentially assures the country elevator a minimum future selling price—and, presumably, a profit—on the grain it has agreed to purchase from the farmer. If the actual price of grain (or cotton) increases above the price in the hedging contract, the commodity exchange requires the country elevator to post additional funds. This requirement is known as a "margin call." Like any party to a futures contract, the country elevator must post the additional funds immediately or the exchange has the right to liquidate the country elevator's position in order to make up for any losses it may have incurred on the country elevator's behalf. This would likely result in a substantial and potentially serious financial loss for the country elevator.

Such prudent hedging strategies have traditionally proven to be a highly cost-effective and successful risk mitigation tool. But in today's market, soaring grain prices are creating enormous margin call requirements, often on a daily basis. Margin call requirements of this magnitude have in turn caused hedging to become an extremely capital intensive activity. This means that country elevators have been forced to devote increasing volumes of funds to meeting margin call requirements, which in turn has driven up their borrowing needs at an unprecedented pace. Another factor driving the demand for credit is the rising cost of agricultural inputs—seed, fuel, fertilizer, *etc.* Many country elevators source these inputs in bulk and sell them at a price that is lower than what farmers would pay if they were to purchase them as individuals. Often, the country elevator sells these inputs to farmers on

*For the purposes of this discussion, the term "country elevator" refers to country elevators and other grain merchandisers as well as cotton cooperatives and private cotton merchandisers.

credit. When the price of these inputs increases, so do the borrowing needs of country elevators.

**CoBank's Response to Our Customers' Credit Needs**

CoBank is committed to serving our traditional customers in the grain and cotton industries. We have taken extraordinary steps to ensure a steady flow of capital to these customers during these volatile market conditions. For example, in the last sixty days CoBank has raised some $700 million in (non-voting) capital from outside investors. This $700 million compares with $1.0 billion in outside capital raised over the previous 6 years. The additional capital will allow CoBank to increase its capacity to meet the borrowing needs of our customers. CoBank has also increased its capacity to accommodate new loans by working with other Farm Credit System institutions and with commercial banks to source the capital required for meeting our customers' credit needs through loan syndications (partial sales to other financial institutions of loans originated by CoBank).

Reflecting the unprecedented demand for credit, CoBank's loans to our "middle market" agribusiness customers increased from just under $7 billion at the end of 2005 to nearly $18 billion at the end of March 2008, an increase of 158 percent (refer to *Figure A*). "Grain marketing and farm supply customers" accounted for 72 percent, or nearly $13 billion, of the total (refer to *Figure B*). In addition, loans to these customers increased by several billion dollars in the month of June 2008 alone, due to the impact on prices of flooding in the grain belt and the need for country elevators and other farm supply cooperatives to prepay suppliers for their 2009 agricultural input supplies. In the past 6 months, CoBank has processed 649 "rush" requests for credit line increases from our customers. This represents 85 percent of the volume of such requests that were approved in all of 2007. In numerous cases, our credit lines to individual grain and farm supply customers have doubled or tripled—from $5 million to $15 million or $50 million to $150 million, for example—while the equity capital and the debt-carrying capacity of these customers has remained essentially unchanged.

**Figure A**

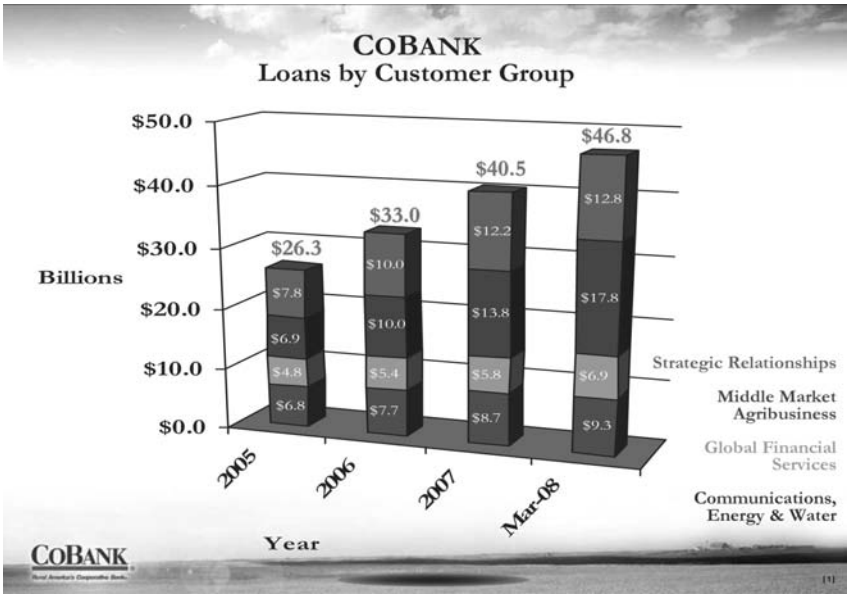
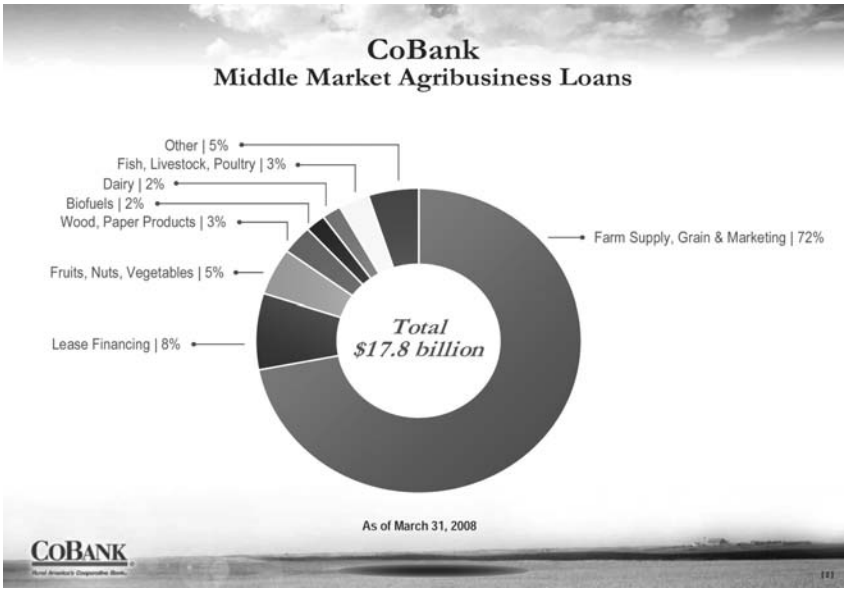


**Figure B**




CoBank is proud of our demonstrated ability to support our customers in these times of such great market volatility. However, as with any financial institution, there are limits to the rate of growth that our capital base—and, accordingly, our credit capacity—can sustain. Like other financial institutions, there are also limits to the concentrations of credit risk that CoBank can maintain in its loan portfolio, for any single borrower or industry sector. Compliance with these risk limits is monitored by our regulator, the Farm Credit Administration, to ensure the safety and soundness of CoBank and the Farm Credit System as a whole. Because CoBank's lending authorities are relatively limited, our loan portfolio is less diversified than that of the typical financial institution. This means that our risk concentration limits can be reached relatively quickly when a segment of the market we serve experiences rapid growth, as country elevators have experienced lately. Unfortunately, even financial institutions with more diversified loan portfolios are finding it difficult to risk-participate with CoBank on our country elevator loans, due to the unpredictable volume of credit that may be required and the single-borrower and industry risk concentrations this could entail.

**Impact of the Credit Constraint on Country elevators and Producers**

Historically, a country elevator's ability to offer forward contracts to farmers has been constrained primarily by the availability of storage space and transportation. Because of the rapid escalation of commodity prices, credit availability has also become a limitation. Accordingly, a country elevator may have to limit forward contracting because it lacks the borrowing capacity to fund the margin calls that would be required if prices increase further. If the country elevator cannot fund margin calls, then it cannot hedge against a potential drop in prices. The country elevator would therefore be assuming all of the price risk associated with offering forward contracts to farmers. It is important to remember that by avoiding excessive risk a farmer-owned country elevator protects the investment of its farmer members in the cooperative business.

For many months, country elevators and their lenders have shouldered the bulk of the risk stemming from volatile and rising commodity prices. For the reasons explained above, it is increasingly difficult and expensive for a country elevator to maintain "short futures" positions for multiple crop years, from the time it enters into a forward purchase contract with a producer until it physically delivers grain to an end-user. Even the major global grain merchandisers have found the cost and risk of maintaining such positions to be extremely difficult, in spite of their substantial financial resources.

In principle, a farmer can himself lock in a future selling price by opening his own hedging account, rather than by forward contracting with a country elevator. This would subject the farmer, instead of the country elevator, to margin calls on short futures contracts, if grain prices increase. Farmers and their lenders have generally been unwilling to take this approach, due to the potentially unlimited funding requirements and in some cases due to a lack of information and/or expertise. Accordingly, as country elevators scale back their forward contracting practices due to the enormous burden of funding margin calls, farmers may be left without the ability to lock in future prices—a tool that traditionally has been crucial to their planting and risk management decisions.

**A Proposal To Address the Credit Constraint**

CoBank remains committed to supporting the industry. There are, however, limits to the concentration of risk that CoBank or any financial institution can assume on a single borrower or industry segment, as explained above. In view of the credit constraint facing grain industry borrowers, we are concerned that some country elevators may find themselves unable to meet the dramatically increased liquidity demands that would result from another round of price increases in the grain markets. Such a liquidity crunch would likely have significant negative consequences for the grain industry and for U.S. agriculture. A widespread liquidity crunch in the industry could entail serious spill-over impacts on the commodity exchanges, the financial markets, and the U.S. economy as whole.

CoBank is working with other concerned industry stakeholders to formulate a solution to reduce the risk of a liquidity crisis in the grain industry and to protect the ability of farmers to market their grain. Among the solutions we are considering is an official guarantee on loans to country elevators and other grain and cotton merchandising businesses. A guarantee of this type would enhance the availability of credit to grain merchandisers for margin calls and for other short-term financing requirements, thereby allowing them to continue to fulfill their traditional and vital role in the U.S. food production system. Because only a fraction of the amount of any guarantees issued would be "on-budget," this alternative would also be a cost-effective means of reducing the risk of a potentially serious and much more costly dislocation in the U.S. grain marketing system and of avoiding the industry consolidation that would likely result from such a dislocation.

In considering such a guarantee, we believe that the following general parameters should guide any proposal:

- Guarantees should be available in a timely fashion (we note that USDA's Commodity Credit Corporation may have the flexibility under existing law to provide a guarantee program for grain and cotton merchandisers);
- Guarantees should support only participants in the physical markets;
- Guarantees would apply to payments due to lenders, not lender losses, to ensure continued liquidity in this highly volatile market; and
- Guarantees would be available regardless of the type of regulated financial institution the grain merchandiser utilizes.

**Conclusion**

These parameters constitute what CoBank considers to be the general outlines of an effective official guarantee program. We welcome the opportunity to work with this Committee, the Department of Agriculture and other government agencies, industry trade associations and stakeholders, and the commercial banking industry to assure that the country elevator system in the U.S. can withstand the stresses that are being placed upon it today. A sound and reliable country elevator system is vital to the U.S. farmer's ability to continue to produce and market the ample supply of grains, oilseeds, cotton and other essential agricultural products from which the U.S. consumer has so greatly benefited.

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SUBMITTED STATEMENT OF WOODS EASTLAND, PRESIDENT AND CEO, STAPLCOTN; MEMBER, BOARD OF DIRECTORS, AMCOT

Mr. Chairman and Members of the Committee, as President and CEO of Staplcotn and a Member of the board of Amcot, I am pleased to submit the following statement on behalf of Amcot, the trade association representing the four major cotton marketing cooperatives in the United States: Staple Cotton Cooperative Association (Staplcotn) of Greenwood, Mississippi; Calcot of Bakersfield, California; Plains Cotton Cooperative Association of Lubbock, Texas; and Carolinas Cotton Growers Cooperative of Raleigh, North Carolina.

I appreciate the earlier opportunity to submit testimony to the Subcommittee on General Farm Commodities and Risk Management for its May 15, 2008, hearing regarding agricultural commodity futures markets. In addition to summarizing that statement, which offered an analysis of the outcomes and effects of the cotton futures markets events of late February and early March, 2008, I would like to offer some suggestions for the Committee's consideration for amending the Commodity Exchange Act.

The public policy of the United States in regard to the practices of regulated commodity exchanges is embodied in section 3 of the Commodity Exchange Act (7 U.S.C. 5), which 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 4a(a) of the Act (7 U.S.C. 6a(a)), "Excessive Speculation as Burden on Interstate Commerce", further states, in pertinent part:

> (a) 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 satisfies 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.

What we have seen in cotton futures markets is a persistent divergence between the cash and futures market for cotton. This has led to disruption in the markets which jeopardize their statutory purpose and perhaps their fundamental existence.

**Where Are We Today in Cotton?**

> (1) The futures and options markets today are not reliable discoverers of prices. When the futures price increases 21.15¢ per pound in absolute terms (as it did between February 20 and March 4, 2008) and 30.87¢ in synthetic value over the same period, while the cash market (as measured by the Seam's Grower to Buyer market) increases by only 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.

(4) Fear of the repetition of these conditions and the potentially ruinous margin calls inherent in such uncontrolled situations prevents cooperatives from carrying out their customary risk management practices for their members, wherein they would normally sell futures contracts at target market levels.

During and since these occurrences, the management and Board of ICE Futures U.S. failed to fulfill its self-regulation requirement under the Act to meet its statutory obligation to the public, and the Commodity Futures Trading Commission failed to fulfill its statutory obligation under the Act to force the management and Board of ICE Futures U.S., and other contract markets similarly impacted, to take such action. I understand that the situation is not unique to cotton. Thus we believe that amendments to the Act are necessary.

**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. In addition, there has been an exponential growth in 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. 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 Spread/ |
| Year | | Traders | Total | Long | Spread | Spec | Total Spec | Non-IT Total | Non-IT 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 management of the agricultural commodity markets through self-regulation, and the CFTC through regulation, are failing in their statutory obligations to achieve these ends. Hopefully these hearings are part of a process by which Congress will ensure that the CFTC will meet its statutory obligations. Failure to do so will result in these markets being managed and regulated primarily for the purpose of providing investment vehicles to attract a flow of investment funds. . Although some may desire this, it does not comport with the Act's straightforward purposes for which the markets are to be regulated: namely, price discovery and risk transfer.

**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 several specific recommendations by June 1, 2008. While the CFTC has taken modest steps with regard to these recommendations, in the main these concerns remain unaddressed. As such, we respectfully recommend that the Committee act on the following recommendations to protect our agricultural markets:

(1) Adopt an amendment to the Commodity Exchange Act to define transactions that qualify as a "hedge", and market participants that qualify as a "hedger", for purposes of the agricultural futures markets. We offer the following draft amendment to the Act for your consideration in addressing this critical issue:

*Amend section 1a of the Commodity Exchange Act (7 U.S.C. 1a) by adding at the appropriate place the following definition:*

> *"(xx)* AGRICULTURAL MARKET HEDGER.—*The term 'hedger' means a person that, in connection with its business—*
>
> > *"(A) can demonstrate that as a part of its normal business practice it makes or takes delivery of the underlying agricultural commodity as part of the commodity's production, distribution, or consumption; and*
> >
> > *"(B) incurs risk, in addition to price risk, related to the commodity"*

We are keenly aware that this is a very complex area of the law. As such, we offer this suggested draft language in good faith, and in the expectation that we might work with the Committee to improve and perfect this language to help to achieve the desired effect of restoring and protecting the integrity of our agricultural futures markets.

(2) Similarly, consideration should be given to whether the current definition of "speculator" adequately and appropriately captures the positions taken by the various speculative participants in agricultural markets. We respectfully suggest the Committee differentiate more than one type of speculator, with appropriately differing position limits and margining requirements for each.

(3) In addition, our cooperatives and their farmer owners are also consumers of substantial quantities of oil and energy based products that are also subject to the effects of futures trading in those commodities. We leave to the Committee whether, and if so how, to define in statute which transactions in energy-related futures and/or in other physically settled commodities outside of agri-

culture are hedge transactions and which traders may be hedgers. We are inclined to believe that a similar hedge definition would be helpful in these markets. However, our experience and expertise in futures trading is concentrated in the cotton and other agricultural futures markets, and we feel strongly that these definitional clarifications should, at a minimum, be applied to these agricultural markets as soon as possible.

(4) Require that index funds be subject to the same speculative position limits and speculative margin requirements as a managed commodity fund, and that their positions be reported at least weekly to the CFTC.

(5) Initial margin required should be mandated so that true agricultural hedgers, as defined in recommendation number (1), above, have the lowest margin requirements, and speculators the highest. The spread of initial margin between these true hedgers and the various classes of speculators must be significantly greater than the current spread between hedgers and speculators.

(6) 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.

(7) 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.

(8) Investigate the events in the cotton futures market of February 20–March 20, 2008, 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.

(9) Finally, we renew our request that the Committee 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.

On behalf of Amcot and the thousands of producer-members of our cooperatives, we would like to sincerely thank the Committee for continuing to investigate these complicated issues. They are of critical importance to the immediate livelihood and the long-term stability of our cotton and other agricultural markets. We look forward to working with you to address these important issues.

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SUBMITTED STATEMENT OF USA RICE FEDERATION AND U.S. RICE PRODUCERS ASSOCIATION

## Introduction

Mr. Chairman and Members of the Committee, the futures markets are intended to serve the primary roles of price discovery and risk management for producers and users of agricultural commodities. Unfortunately, for several months the markets have been volatile and unsettled, resulting in a divergence between cash and futures prices and significant increases in margin requirements. This has been observed across almost all agricultural commodity contracts on the various exchanges, but we will focus our comments on the rice market and the Chicago Board of Trade rice contract.

Due to the critical importance of these markets to the marketing plans and livelihood of rice producers and all of U.S. agriculture, we appreciate the Committee conducting these hearings to review legislation to amend the Commodity Exchange Act. On behalf of the U.S. rice industry, we would like to take this opportunity to provide several recommendations for your consideration in this regard.

**Background**

There are a number of fundamental factors in the market that are leading to higher rice prices including:

- tighter global supply based on lower production due to weather events and acreage shifts to other crops and increased demand;
- increased costs of production; and
- increased energy costs that lead to higher storage and transportation costs.

The presence of all these factors should lead to convergence of cash and futures prices, but we are experiencing a lack of convergence due in part to increased participation by speculators in the market. Speculator participation in these markets is important to provide liquidity to the market, but there must be limits on participation. There have been instances of funds owning more of some crops on paper than will be produced during that crop year. This level of participation has hampered the price discovery role of the market, has damaged the cash market for rice, and has diminished rice producers' profitability.

We are concerned that this lack of convergence will continue as long as speculators and funds remain in the market to the current degree as unrestricted buyers. As a result, we will continue to see very few, if any, commercial marketers offering forward pricing opportunities. Many commercial market participants have exhausted their working capital and credit lines available for margin requirements and are therefore no longer in the market. This is particularly damaging to producers as they are no longer able to forward price their expected harvest, leaving them exposed to significant price risk. Producers are facing this price risk at a time of record high input costs. In fact, many producers are still unable to lock in sales prices through forward contracts for their expected crop production for 2009. Because of this, it is clear that the futures market is no longer performing one of its primary functions—hedging and price risk management.

The on-line Glossary of futures terms of the Commodity Futures Trading Commission (CFTC) defines the term "hedging" as follows:

> *"Hedging: Taking a position in a futures market opposite to a position held in the cash market to minimize the risk of financial loss from an adverse price change; or a purchase or sale of futures as a temporary substitute for a cash transaction that will occur later. One can hedge either a long cash market position (e.g.,* one owns the cash commodity) or a short cash market position (*e.g.,* one plans on buying the cash commodity in the future)."

On its face this appears to be a common sense definition for the hedging of agricultural commodities by commercial market participants. However, over time the "hedgers" have grown to include large numbers of entities other than commercial participants in the agricultural industry.

**Recommendation #1: Clearer Definitions of Agriculture Market Hedgers and Speculators**

**For purposes of agricultural futures markets, hedgers should be defined as those physical market participants tied to the physical commodity. By contrast, those agricultural futures market participants not tied to the physical commodity should be defined as speculators. In addition, increased speculative margin requirements and tighter position limits for speculators could also help improve the situation.**

We believe an excessive level of participation by speculators is at least partially responsible for the current market situation. This includes entities other than commercial agricultural market participants that the CFTC may currently define as "hedgers". Without the improvements recommended above, we believe the market will continue to be lacking in its ability to perform its two primary functions of price discovery and hedging. This critical failure needs to be corrected as soon as possible. These necessary steps must be taken to ensure that commercials can reenter the market and perform their role as hedgers for the physical commodity.

**Recommendation #2: Speculative Margin Requirements**

**While it is important to insure there is adequate margin to cover any default, we urge the consideration of a requirement of consistently higher ini-**

**tial and maintenance margin requirements for speculators than for hedgers (redefined as described in Recommendation #1, above). Congress and the CFTC should consider more closely linking the margin requirement in rice and other agricultural futures markets to both the price level and the amount of market volatility in the market.**

We are of the opinion that the rice market has suffered from being "cornered" in a non-traditional sense—not by one market participant—but by the fact that hedgers can no longer afford to take short positions (sell) in the market while speculators and funds continue to take long positions (buy), creating a "demand" market in rice that is self-fulfilling.

We completely agree that margin requirements must be sufficient to insure performance, however we also suggest that Congress and the Commission consider that only those that deal in or are tied directly to the physical commodity—including producers, processors, merchants, marketers, and end-users—be considered hedgers for determining necessary margin requirements on this category of market participants. On the other hand, index, pension, and other funds not tied to the physical commodity should be considered speculators with different (higher) margin requirements (with respect to both initial and maintenance margin) and separate position limits.

Again, due to the increasing margin requirements resulting from increased market volatility, more and more commercial agricultural market participants are exiting the market as their available capital and lines of credit are becoming increasingly stretched to the point they can no longer afford to hedge their price risks. The result is that the markets are failing in their ability to perform their two primary statutory functions of price discovery and hedging.

**Recommendation #3: Rice Futures Delivery System; Increased Storage Rates; Cash Settlement for Rice Futures**

**We urge the Committee and the CFTC to review the delivery system for rice futures contracts, and also to consider raising rice storage rates. Some market participants believe that adding delivery points would help improve convergence in the rice futures markets. In addition, we would urge a review of whether the use of cash settlement of rice futures contracts would better serve producers, hedgers, and others using these vital markets.**

**Recommendation #4: Enhance Reporting and Transparency of Rice Futures Trading and Markets**

**Add rice to the weekly CFTC supplemental Commitment of Traders report, and provide reporting categories for speculators and funds that are separate from the traditional hedgers (consistent with Recommendation #1, above).**

In order to maintain the integrity of these markets, it is important to provide increased transparency of market activities. The above actions would help to provide a more comprehensive view of what is occurring in the rice futures market to the benefit of rice producers, processors, and marketers.

**Conclusion**

In summary, we believe that the participation of speculators (funds) in the market is leading to increased volatility and negatively impacting the ability of the futures markets to perform its two primary statutory functions of providing price discovery and hedging. As the increased margin requirements, volatility, and lack of confidence cause more and more commercials to withdraw from the market, the divergence between cash and futures prices will only worsen. If and when the funds begin to withdraw from the market, we could be in store for a severe price correction that could lead to significant financial losses and instability, which could further prohibit participation by commercials and producers. Steps need to be taken to address this situation and to prevent its reoccurrence in the future.

We appreciate the opportunity to share our views and recommendations with the Committee, and look forward to working with the Committee, the CFTC, and others in agriculture to help address the current market situation so that all in the rice industry can once again have confidence that the futures market will meet the industry's price discovery and risk management needs.

Thank you again for convening these timely and important hearings. If you have any questions or would like any additional information, please contact Mr. Reece Langley at the USA Rice Federation at [Redacted] or [Redacted], or Mr. Fred Clark on behalf of the U.S. Rice Producers Association at [Redacted] or [Redacted].

# HEARING TO REVIEW LEGISLATION AMENDING THE COMMODITY EXCHANGE ACT

**THURSDAY, JULY 10, 2008**

HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
*Washington, D.C.*

The Committee met, pursuant to call, at 10:12 a.m., in Room 1300, Longworth House Office Building, Hon. Collin C. Peterson [Chairman of the Committee] Presiding.

Present: Representatives Peterson, Holden, Etheridge, Baca, Cardoza, Scott, Marshall, Herseth Sandlin, Cuellar, Costa, Salazar, Ellsworth, Boyda, Space, Walz, Gillibrand, Kagen, Pomeroy, Barrow, Lampson, Donnelly, Mahoney, Childers, Goodlatte, Moran, Hayes, Johnson, Graves, Rogers, King, Neugebauer, Boustany, Kuhl, Foxx, Conaway, Fortenberry, Smith, Walberg, and Latta.

Staff Present: Adam Durand, Alejandra Gonzalez-Arias, Scott Kuschmider, John Riley, Kristin Sosanie, Bryan Dierlam, Alise Kowalski, Kevin Kramp, Josh Maxwell, and Jamie Weyer.

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

The CHAIRMAN. The Committee will come to order. We welcome the witnesses. What we are doing here today is to try to focus in on the different areas that are under question that have been addressed in different bills that have been introduced. We tried to set these panels up to focus in on the specific areas that have been raised during this debate. And we are trying to do this in a way to focus in, not get off and mix up different parts of this.

So the first panel here is dealing with swaps. All right. The swaps and over-the-counter market and so forth. And we want to welcome the panel: Mr. Greg Zerzan, Counsel and Head of Global Public Policy, International Swaps and Derivatives Association; Mr. Charles Vice, President and the COO, Chief Operating Officer, of the IntercontinentalExchange, ICE, of Atlanta, Georgia; Mr. Michael Comstock, the acting Director of the City of Mesa, Arizona, Gas System on behalf of the American Public Gas Association; Mr. Michael Greenberger, University of Maryland School of Law, who teaches a course in this area, as I understand it, and he has offered to maybe bring some of us in as his students and try to educate us a little bit, which at least I know I could use; Dr. Craig Pirrong, who is a Professor of Finance and Director of Global Energy Management Institute of Bauer College of Business, University of Houston, from Houston, Texas.

So we welcome the panel, and I know at least this Member has a lot to learn, and there are a lot of differences of opinion. We are hoping that through this process we can sort through some of this.

I spent 10 years or better trying to understand dairy policy in this country, and it is one of those things that whenever I would get to the point where I thought I understood it, then I would learn something that would completely undermine everything that I thought I knew. I am finding that this issue is very much the same as that. And so we are hoping that this exercise will help us to understand better the situation and get to the bottom line.

[The prepared statement of Mr. Peterson follows:]

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

Good morning and welcome to today's hearing.

Today marks the second of three hearings this week to review legislative proposals to amend the Commodity Exchange Act.

We have three full panels today and a lot of ground to cover, so I will keep this very brief and not repeat what I said yesterday about the purpose of these hearings.

Yesterday we heard from six of our House colleagues who have introduced bills that would amend regulation of commodity futures markets. Today and tomorrow, we will hear from stakeholder groups about these and other legislative proposals, as well as the major issues currently surrounding commodity futures and options markets.

What we intend to do over the next 2 days is have each panel examine one of these subjects in detail. Today's three panels will look at:

- The swaps and the over-the-counter market;
- Pension fund and index funds; and
- Hedge exemptions and speculation position limits.

Today's witnesses will hopefully shed some light on these topics and how legislation that has been introduced would affect them. Some groups, of course, have vested interests in more than just one area, and that will be reflected in their broader written testimony submitted for the record. But with so much to get to today, we will try and keep this as focused as possible.

At this time, I now yield to the Ranking Member of the Committee, Mr. Goodlatte for an opening statement.

The CHAIRMAN. I recognize the gentleman from Virginia for a statement.

## OPENING STATEMENT OF HON. BOB GOODLATTE, A REPRESENTATIVE IN CONGRESS FROM VIRGINIA

Mr. GOODLATTE. Thank you, Mr. Chairman. I was just going to ask if you had now mastered dairy policy.

The CHAIRMAN. No. But they say there are five people in the United States that really understand it, and those five people are lying.

Mr. GOODLATTE. Well, thank you, Mr. Chairman, I look forward to this testimony today. This is the second in a series of hearings to try to uncover the truth about futures trading and what impact it may be having on the price of energy, particularly oil. And I think it is very important that we learn from all of the witnesses that we have here today and attempt to determine just exactly how well the Commodity Futures Trading Commission and the laws they operate under are working. So I will approach this with an open mind.

I will add, however, as I have at each of these hearings, that while this is an important topic for us and is the jurisdiction of our

Committee, something that is not the jurisdiction of our Committee is the most important thing that we as a Congress can do to address the problem of the high cost of energy, and that is to enact policies that would enable an increase in the domestic supply of all sources of energy, be it oil, natural gas, clean-burning coal, nuclear power, new technologies, renewable fuels. All of these things could use the Congress clearing the way to drill on Federal lands in Alaska and the Rockies, offshore, to tap into what some believe is the largest natural gas reserve in the world in the Gulf of Mexico that is untapped. All of these things are the number one thing that this Congress needs to be doing.

And I know I have a lot of agreement on that issue on both sides of the aisle in this Committee. I just wish that that would be reflected in the leadership of the House in allowing some of the many bills introduced by Members on both sides of the aisle to get to the floor of the House so that we could address them and truly address the problem with the shortage of energy that we have in this country. I think this is by far the number one cause of rapidly rising prices of not just oil, but other sources of energy as well. This is caused by the fact that supply simply has not kept up with growing demand around the world.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

If anybody else has any statement, they will be made part of the record, without objection.

[The prepared statement of Mr. Graves follows:]

PREPARED STATEMENT OF HON. SAM GRAVES, A REPRESENTATIVE IN CONGRESS FROM MISSOURI

Thank you, Chairman Peterson and Ranking Member Goodlatte for holding this hearing on speculation in the marketplace and its impact on prices.

As I have mentioned in the past there is no silver bullet solution to high energy costs, but rather a combination of things. Most importantly, we must domestically produce fuel that we have available, including in Alaska and in the Outer Continental Shelf. Opening domestic resources for production can be done in an environmentally safe way and can have a tremendous impact in reducing our reliance on foreign sources of fuel. I agree with the majority of Americans that this will help bring gas prices down.

I also believe that alternative fuels including wind, ethanol, biodiesel, hydrogen, and others will help reduce our consumption of traditional fossil fuels. Alternative fuels are not only cleaner for our environment but their usage helps lower demand for crude oil and will help bring prices down.

Today, we are looking at speculation in the market. I believe that speculation has a role to play in discovering the true price of a product. However, there are times when I feel that excessive speculation, misinformation, and a lack of transparency can drive prices up.

I have played an active roll in ensuring that traders are not cheating the system. First by introducing legislation in the 109th Congress, H.R. 1638, the Commodities Exchange Improvements Act of 2005, then by co-authoring legislation in the 110th Congress, H.R. 3009, Market Transparency Reporting of United States Transactions Act of 2007, and most recently by working with my colleagues in the farm bill to shed more light on all energy commodities and how they are traded.

As you can see my record speaks for itself. I look forward to working with my colleagues to ensure the American public and the people of the 6th District are not being cheated by big traders in order to make a buck.

Thank you.

The CHAIRMAN. So we will move to the panel. Panel members, your statements will be made part of the record. We would encour-

age you to summarize and talk to us in a way that we may understand as best you can.

And so we will start with Mr. Zerzan, and we appreciate you being with us today and taking the time to help educate us.

**STATEMENT OF GREG ZERZAN, COUNSEL AND HEAD OF GLOBAL PUBLIC POLICY, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, WASHINGTON, D.C.**

Mr. ZERZAN. Thank you, Mr. Chairman. And thank you, Members of the Committee.

As this Committee knows, ISDA is the world's largest global financial services trade association. We represent members in the over-the-counter derivatives industry. We have over 830 members in over 52 countries around the world, and we routinely deal with these types of issues in jurisdictions in Europe, Asia, Latin America, as well as the United States.

As this Committee knows, over-the-counter derivatives are primarily risk-management products. They were developed in the United States in the early 1980s as a means of transferring risk via the use of individually negotiated bilateral contracts. Despite the fact that these contracts were first invented in the U.S., the primary source of over-the-counter derivatives business in the world now is the United Kingdom.

This Committee knows, because we spent most of last year discussing one of the main topics that is of concern to ISDA in the current debate, and that is proposals which would seek to amend or repeal the protections from bilaterally negotiated contracts. These are primarily found in sections 2(g) and 2(h) of the Commodity Exchange Act. These provisions allow parties to enter into a contract with the assurance that it will be legally enforceable. And again, there is a long history of these contracts, including a long history of case law upholding the legal documentation which ISDA first developed.

And I won't dwell on the provisions of 2(g) and 2(h) because this was the subject of multiple hearings and multiple discussions in this Committee over the last year. And some of the concerns regarding over-the-counter derivatives were, in fact, addressed by the passage of the farm bill. Under this Committee's leadership, greater transparency was extended to electronic exempt commercial markets. And that legislative provision was widely embraced both on a bipartisan basis, by industry, by consumer groups, by end-users and by regulators. And that achievement, which was less than 2 months ago, deserves to be roundly applauded. So thank you for that.

The other provision which is of concern to ISDA are proposals which would remove the ability of swap dealers to use the futures markets to hedge their swap risk. And it is important to understand that swap dealers are indeed hedging a *bona fide* business risk. These are the risks that are passed on to the swap dealers from their customers. In many cases those risks are passed on to the swap dealers because the customers either can't obtain protection through the futures markets or are unwilling for a variety of operational issues to engage futures.

And just a quick example of this is the case of airlines who seek to hedge the risk of fluctuations in the price of jet fuel, but there is no widely traded jet fuel futures contract, so typically an airline will enter into a jet fuel swap, and the swap dealer will then hedge its risk under that contract by entering into a basis swap in West Texas Intermediate crude. So, as you can see, the swap dealers are both performing a valuable function which helps end-users and commercial participants, and they are also hedging their own *bona fide* business risk. So we are very concerned about any proposals which would seek to prevent swap dealers from hedging these risks.

Last, I would note that during the course of the debate over the provisions that were enacted into the farm bill, this Committee and this Congress showed great sensitivity to the competitive issues that are associated with regulation of financial markets. As you know, around the world there is tremendous competition to attract the jobs and the revenues that come with financial services, and there have been great concerns expressed about America potentially losing its competitive advantage in these areas. I am hopeful that Congress will continue to bear in mind the dangers that are posed to our country and our economy if we implement overly restrictive measures which make it more attractive to do business outside the United States.

I thank the Committee again for your leadership, and I look forward to answering any questions.

[The prepared statement of Mr. Zerzan follows:]

PREPARED STATEMENT OF GREG ZERZAN, COUNSEL AND HEAD OF GLOBAL PUBLIC POLICY, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, WASHINGTON, D.C.

**Introduction**

Thank you very much for inviting ISDA to testify today regarding over-the-counter (OTC) derivatives, the Commodity Exchange Act and recent activity in the commodity markets.

**The Purpose and Role of OTC Derivatives in the Economy**

As the Members of this Committee know, OTC derivatives are used for a variety of risk management purposes. Initially developed in the 1980s, OTC derivatives have quickly become a core component of the risk management operations of financial institutions, manufacturers, producers, multinational corporations and investors both in the U.S. and around the world. OTC derivatives are privately negotiated contracts, with the material terms of a transaction worked out between the parties. In this respect they differ significantly from exchange traded futures and options, which are standardized and fungible instruments subject to offset through the purchase of a contract with the opposite exposure.

In the energy commodity space OTC derivatives are used by a broad segment of market users looking to manage risks related to future price movements of energy. For instance, a large producer that is exposed to the price of oil through normal costs like fuel and the price of fertilizer can hedge its risks by entering into a swap agreement whereby it agrees to pay a fixed amount of money on a specified quantity, for instance $140 a barrel, over a specified period in exchange for receiving the floating price of crude over that same time. In this way the producer will guarantee that its economic exposure is no more than $140 a barrel and can budget its future operations on that basis. Likewise a utility company that relies on natural gas to power its generators can lock-in the future price of the commodity by entering into a swap agreement with a counterparty such as a bank or investment firm that is better equipped to deal with the risk of floating prices.

OTC derivatives were invented to allow companies to mitigate price shocks by passing on those risks to others that have the opposite exposure, or are better suited to manage them. These risks can be managed through custom-tailored contracts exactly suited to the company's risk management needs.

In some cases OTC derivatives are used to gain exposure to some underlying reference asset. For instance an institutional market participant such as a pension fund or university endowment might utilize an OTC derivative to benefit from the increase in the price of a basket of stocks or commodities. The reasons an institutional market participant might prefer to use an OTC derivative instead of futures or stocks can vary, but could include such factors as costs, the ease with which a swap agreement can provide diversification, legal constraints on its ability to invest directly in certain asset classes, or the need to custom tailor a transaction for portfolio management purposes. Cost benefits are an especially important consideration; an investor can use a total return swap to access exposure to an underlying commodity without having to purchase and mange a bundle of futures contracts with different delivery dates. Equally important is that OTC derivatives are cash-settled, meaning an investor need not avoid physical delivery by purchasing offsetting futures contracts (and incurring those transaction costs as well).

OTC derivatives play a critical role in the global economy, and the markets are international in scope. However, despite the fact that OTC derivatives were first created in the United States, London has become the center of the global OTC derivatives business with roughly 43 percent of the world's daily turnover occurring there.

**Derivatives Are Not the Cause of Rising Commodity Prices**

Recently there have been widespread accusations that derivatives markets, and in particular speculators in derivatives markets, are responsible for rising commodity prices.[1] Some accuse speculators of driving up the price of oil beyond levels justified by fundamental economic factors, as well as increasing volatility. Others point to the presence of investors in the market; it is asserted that even investors with a long-term perspective enter as buyers and put upward pressure on prices. And finally, because commodity derivatives, both exchange-traded and over-the-counter, reduce the cost of transacting in commodity markets, some call for restrictions on derivatives activity as a way to reduce pressure on prices. Unfortunately these arguments misunderstand the role of derivatives in informing commodity prices. Putting tighter restrictions and further regulation on derivatives will not reduce the price of oil, and might even make it more volatile.

Commodity derivative market participants can be divided into three categories. The first category is "commercial" participants, which include oil producers along with oil consumers such as airlines and refineries. Commercial participants often, but not always, use derivatives to hedge their exposures to prices and thereby reduce risks. The second category is noncommercial participants, which includes hedge funds, pension funds, and commodity trading advisers. Noncommercials are often identified as speculators, that is, participants that seek to take on risk in order to benefit from price increases or decreases. The third category is intermediaries, also known as dealers, which consist of banks and other financial firms as well as energy trading subsidiaries of energy producers and utilities. Intermediaries stand between hedgers and speculators in order to make a market.

All three types of participants act as both hedgers and speculators at different times, and all three types are necessary to an efficient and liquid market. For hedgers to be able to transfer unwanted risk there has to be someone to take on those risks. If dealers cannot find another hedger with the opposite, offsetting risk then dealers will look to speculators to take on those risks. In such a market, restricting and otherwise raising costs to speculators will ultimately raise costs to hedgers and make it more difficult to manage the volatility of the prices they seek to manage.

A recent criticism of derivatives has been that prices are higher than economic fundamentals would justify because both speculators and investors place excessive upward pressure on prices. According to this argument, investors use derivatives to enter as buyers in order to enhance their returns and to hedge against inflation, while speculators buy in anticipation of prices going even higher.

However, neither speculators, investors nor other derivative market participants are the cause of the level and volatility of oil prices. The reason is straightforward: physical possession of oil (or any other commodity) is necessary to drive up prices. Evidence appears to be lacking to support the necessary condition that speculators or investors have been taking physical possession of oil and withholding it from the global market.

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[1] It is worth noting that prices for a wide range of commodities for which there are no active exchange markets have likewise seen tremendous price appreciation. Since 2001 cadmium and molybdenum prices are up over 1,000%; rice has appreciated over 500%; iron ore and steel have increased over 300%. Onions have increased over 300% this year alone as of April 2008.

The mechanics of the market can be explained as follows: assume that a combination of speculators, hedgers, and investors all take long futures positions. In isolation, all of these could potentially exert upward pressure on prices were it not for the presence of two other factors. First, for every long position there has to be a short position (a seller) on the other side. Second, all speculators, hedgers, and investors with long positions will be obligated to take physical delivery of oil when the contract matures unless they exit out of the contract beforehand. By selling contracts to exit their position (and virtually all of these market participants will do so) downward pressure will be placed on the price of oil. If the price were simply high because of all the pressure from buyers, then the downward pressure from the selling would cause the price to fall. But if the price of oil were to remain high anyway (as has been the case recently), it must necessarily be because there are participants with long positions who are willing to buy and take possession of oil. And this in turn could be either because someone has bought up oil supplies so other buyers drive up the price—which is market manipulation and therefore illegal—or because demand for the physical commodity has increased relative to the supply available, thereby leading to a higher price.

The above also applies with regard to over-the-counter markets such as swaps. OTC derivatives are bilateral agreements, the vast majority of which are cash-settled (and thus do not involve physical delivery). Additionally many OTC derivatives are hedged using futures contracts, which as explained above means the contracts are eventually sold prior to maturity and thus exert downward pressure on prices.

Derivatives markets are price discovery markets; they reflect the willingness of buyers and sellers to agree to a price for any given commodity. While derivatives can help inform markets as to expectations of future prices they are naturally checked by the actual physical supply of the underlying commodity; in other words it is the market forces of supply and demand, not derivatives, which are the cause of rising commodity prices.

**Recent Legal Developments and Legislative Proposals**

*(a) Recent Changes in U.S. Law*

Since passage of the Commodity Futures Modernization Act in 2000 there have been efforts to amend the provisions of that law relating to OTC energy transactions. Indeed, Congress has been very active in increasing Federal oversight of the energy markets, such as the grants of anti-fraud authority to the Federal Energy Regulatory Commission over the natural gas and electricity markets (as part of the Energy Policy Act of 2005) and to the Federal Trade Commission with respect to the wholesale petroleum market (as part of the Energy Security and Independence Act of 2007). It is worth noting that the precise jurisdictional parameters of the FERC authority are still being decided; meanwhile the FTC has just begun its rulemaking process.

Meanwhile less than 2 months ago Congress, lead by this Committee, undertook the most sweeping changes to the Commodity Exchange Act since the passage of the CFMA. As you are aware the amendments to the law made by the CFTC Reauthorization Act of 2008, contained as a title of the farm bill, occurred after a year of hearings, countless conversations among policy leaders and market participants, consumer groups and producers and manufacturers, and the consideration and detailed recommendations of the President's Working Group on Financial Markets. The amendments to the law were made within the context of a thorough and carefully deliberated analysis of the current market, changes in the industry since passage of the CFMA, and a careful balancing of the costs and benefits of increasing oversight of the energy derivatives business. Ultimately, led by this Committee, the Congress passed legislation that won nearly unanimous praise from the industry, consumer groups and the regulatory community.

The provisions of the recently passed farm bill made important changes to how OTC markets are regulated, and are worth considering. For this discussion the most relevant provisions of the law are those relating to exempt commercial markets, which are markets among sophisticated commercial users that operate electronically. Under the new law those exempt OTC markets which list "significant price discovery contracts" are required to submit themselves to a new, principles-based regulatory regime that is modeled on those imposed on fully regulated markets. However, recognizing the unique nature of these markets and the fact they are limited to professional participants, Congress chose to create a modified structure that retains important regulatory measures such as monitoring for abusive behavior, the ability to stop trading and the imposition of accountability limits while at the same time permitting the maximum amount of flexibility in order to encourage trading and accommodate innovation. Congress also created large trader reporting for significant price discover contracts as well as for agreements which are treated as fun-

gible with such contracts by a clearinghouse. These provisions require substantive new reporting requirements for OTC derivatives.

Congress carefully balanced the desire for greater oversight of exempt commercial markets with a recognition of the global nature of these markets, the reality of international competition for the financial services business and an acknowledgement of the important role these markets play in allowing U.S. companies to manage risk.

Over the last 3 years increased legal requirements have significantly expanded regulatory oversight and knowledge about the U.S. energy market. While some may feel these changes were overdue, there can be no question that the rapid changes in the legal and regulatory requirements for engaging in energy transactions have been challenging for market participants. Because the exact scope and requirements of these changes in the law are still being implemented by regulators (and the precise compliance requirements still being discovered by market users) it is not clear what effect these changes will have on the markets. Nevertheless policymakers may be concerned about the business cost of imposing too many changes too quickly; the worst possible outcome would be one in which the ability of the market to produce services useful to consumers is impeded by regulatory and compliance issues.

*(b) Current Legislative Proposals*

A variety of approaches have been suggested for addressing rising commodity prices and the role of derivatives in commodity markets.[2] Some of these focus on the role of particular classes of market participants such as institutional investors and speculators; others would adjust margin requirements; some address the regulation of foreign boards of trade; still others would modify or repeal existing protections for OTC energy derivatives. ISDA's testimony will focus on this last category.

H.R. 6264 makes it unlawful to enter into a transaction in an energy commodity[3] in reliance on the 2(h) exemption or the 2(g) exclusion, unless the party entering into the transaction certifies that it has the capacity to take physical delivery of the energy commodity. H.R. 6330 requires that "included energy transactions," which are transactions in energy commodities for future delivery that provide for a delivery point of the energy commodity in the U.S., be conducted on a designated contract market (DCM) or derivative transaction execution facility (DTEF); "bilateral included energy transactions" are subject to record-keeping and reporting requirements. The legislation would also curtail the CFTC's ability to use its exemptive authority with respect to included energy transactions. Separately, H.R. 6330 would expand the authority of the Federal Energy Regulatory Commission to issue cease-and-desist orders under the National Gas Act and the Federal Power Act; given the continued jurisdictional uncertainty regarding the division of CFTC and FERC authority one can envision a future in which market participants are uncertain as to which orders from which regulator they must seek to comply. H.R. 6341 would require all energy derivatives to be conducted on a registered futures exchange by removing energy transactions from the protections of the 2(h) exemption and the 2(g) exclusion. H.R. 6372 would remove energy commodities from the 2(g) exclusion and impose position and transaction requirements on energy swaps.

These proposals are not new. Since passage of the CFMA bills have regularly been introduced that would amend the protections for bilateral, privately negotiated swap agreements contained in the law. The above proposals were considered and rejected by Congress earlier this year when it adopted the new oversight provisions contained in the farm bill. Nothing that has happened in the last 2 months should fundamentally alter the carefully considered judgment of this Committee and Congress. Suffice it to say that the same rationale which led Congress to reject calls to restrict the ability of American companies to manage their very real risk of rising energy prices just 2 months ago hold even more true today. The protections of 2(g) and 2(h) allow parties to privately negotiate custom tailored risk management contracts. The above proposals, which seek to remove American companies' ability to do so, remain misdirected and potentially harmful.

Another area of interest to participants in the OTC derivatives markets are proposals to require separate disclosure or disaggregation of trading by index traders and "swap dealers". In considering such proposals it is important to remember that one of the benefits provided by regulated exchanges is the anonymity they provide

[2] There are currently 23 proposed bills on this topic: Senate bills numbered 2991, 2995, 3044, 3122, 3129, 3130, 3131, 3185, 3202 and 3205 and House bills numbered 6130, 6238, 6264, 6279, 6284, 6330, 6334, 6341, 6346, 6349, 6372, 6377, and 6406.

[3] The proposed bills vary slightly in their definitions, but in general an energy commodity may include coal, crude oil, gasoline, diesel fuel, heating oil, propane, electricity, natural gas, any fuel derived from oil, any transportation fuel, uranium, and any other commodity as determined by the CFTC.

to traders; futures markets reveal the prices market participants pay, not their motivations in making trades. Measures which seek to remove that anonymity could make traders seek markets which protect their ability to not reveal their motivations or individual market positions. Policymakers should carefully balance the legitimate desire of market participants to keep their market strategies and identities undisclosed. In any new reporting regime it should be ensured that no disclosure is required which would put any class of market participant at a disadvantage, including creating opportunities for other market participants to "front-run".

One additional area of particular concern are proposals such as those in H.R. 6330 to restrict or otherwise limit swap dealers and other intermediaries access to the futures markets to hedge their exposures to their counterparties. As already described, dealers and intermediaries provide valuable hedging, risk management and customized product offerings to their counterparties. A key part of these undertakings is the ability of these dealers and intermediaries to access the futures markets to lay off their exposures either on a case-by-case or on a portfolio basis. Without ready access to futures markets for hedging, these services would be more expensive and less efficient. At the same time, the futures markets would miss the important liquidity and pricing information these transactions provide. Forcing dealers and intermediaries to use non-U.S. markets or to create a network of bilateral hedging locations ill serves the dealers, their counterparties or the U.S. futures markets.

**Competitive Considerations**

As noted previously, the OTC derivatives markets are global in scope. Throughout the world governments have come to appreciate the value a dynamic financial services industry provides to local companies, as well as the significant benefits they provide to the national economy. National governments throughout Europe and Asia are actively competing to attract business and become financial centers. Recent regulatory overhauls in the UK, the European Community, Japan and South Korea all were guided in part by the desire to attract international financial services while at the same time bolstering local markets.

The U.S. has long been a world leader in financial services. Currently the financial services industry provides one in every 20 jobs in the U.S. while producing 8% of America's gross domestic product. The financial services sector is also a source of high tech innovation and a leading producer of "new economy," knowledge-based jobs. A leading example is the Atlanta-based IntercontinentalExchange (ICE), which started in 2000 and now comprises one of the world's leading derivatives markets. ICE operates both OTC and regulated futures exchanges, and purchased the London-based International Petroleum Exchange to extend its presence into Europe. From its beginnings as a start-up company ICE is now a member of the S&P 500 and an employer of hundreds of Americans. Without the changes in U.S. law created by the CFMA it is fair to say that ICE would not have achieved such tremendous success.

During discussion of the farm bill this Committee in particular was sensitive to issues of U.S. competitiveness and the desire to ensure America's position as a world-leading financial center was not harmed by inappropriate or unnecessary changes to U.S. law. The competitive threats to the U.S. have not disappeared since those deliberations. Although some nations have moved to restrict derivatives markets in response to rising commodity prices most of the U.S.'s immediate competitors have adopted a wait-and-see approach. In the European Union the European Commission has issued a white paper seeking to explore the causes of rising prices that has stopped well short of formal proposals to fundamentally alter the regulation of derivatives markets.[4] In the UK the Treasury Committee of the House of Commons also plans to investigate recent increases in commodity prices. It is worth noting that in the U.S. the CFTC has began a comprehensive inquiry into rising commodity prices; whatever information the Commission receives will no doubt prove useful in considering public policy choices.

Given the global nature of the OTC derivatives markets and the financial services industry in general, there is no question that the imposition of overly restrictive regulatory requirements will lead to the reallocation of financial services business from the U.S. to more friendly jurisdictions. As damaging as these prospects might be to the U.S. economy an even greater danger lies in the possibility that assets will be priced in currencies other than U.S. dollars.

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[4] See for example European Commission, *Communication on Rising Food Prices,* (May 20, 2008). The Commission continues its deliberations under the Markets in Financial Instruments Directive regarding the application of that law to various types of commodity businesses.

For example, currently the world price of crude is set in U.S. dollars, a currency which America obviously owns a monopoly in producing. There are many reasons the world prefers to price crude in dollars, including a favorable investment climate in the U.S.; the historic strength of the dollar relative to other currencies; the widespread confidence the world has in the continued vitality of the U.S. economy; and ultimately the faith market participants have that the U.S. will honor its obligations. One particularly important reason to price crude (and other assets) in U.S. dollars is the existence in the U.S. of liquid, efficient markets for pricing assets. Without this mechanism for establishing prices there would be inefficiencies in the markets that would cause problems for producers, refiners, consumers and financial market participants alike.

Measures which would impair the ability of U.S. markets to price assets and attract investors would likewise remove a significant incentive for the rest of the world to use dollars as the preferred pricing currency. Such measures would need not include an outright ban on derivatives (though it is worth noting that such a ban is not without historical precedent);[5] measures which remove or limit certain market participants could likewise remove liquidity and harm the efficient functioning of the markets, thus forcing more market participants out, creating a downward spiral. It goes without saying that the pricing of assets in currencies other than U.S. dollars runs contrary to America's national interest.

**Conclusion**

Over the last year Congress and this Committee have carefully deliberated over the question as to what level of oversight is appropriate for OTC energy markets. After multiple hearings and considering the views of market participants, end-users, consumer advocates and regulators, Congress less than 2 months ago passed broad changes to the law which carefully balanced the needs of these groups as well as concerns about the continued attractiveness of the U.S. as a world financial center. These changes, which are still being implemented, should be given time to work. Furthermore, Congress should provide increased funding to the CFTC to ensure that the Commission has the resources necessary to execute upon its new authority and the numerous regulatory initiatives the Commission has recently announced.

As noted above, increasing regulation on over-the-counter derivatives will not lower the price of energy or other commodities. However, doing so will create incentives for relocating markets to outside of the U.S., remove tools for producers and commercial users to manage their risks, and harm the U.S. economy. This Committee has historically been very sensitive to these dangers. ISDA thanks the Committee for your careful examination of these issues, and your continued leadership.

The CHAIRMAN. Thank you very much. And I am sure there will be plenty of questions when we get to that point.

We now will hear from Mr. Vice from ICE.

## STATEMENT OF CHARLES A. VICE, PRESIDENT AND COO, INTERCONTINENTALEXCHANGE, INC., ATLANTA, GA

Mr. VICE. Thank you, Mr. Chairman. I am Chuck Vice, President of ICE. I appreciate the opportunity to appear before you today to give our views.

As brief background, ICE operates several global marketplaces and futures and OTC derivatives across the range of product classes including agriculture and energy commodities, foreign exchange and equity indexes. The ICE holding company globally operates one OTC energy market and owns three futures exchanges in the U.S., U.K. and Canada; each was separately acquired over the last 7 years.

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[5] In 1958 Congress adopted an outright prohibition on the trading of onion futures in the United States, a ban which remains to this day. As noted above (*ante* fn. 1), onion prices have risen 300% as of April of this year. Fortune magazine recently ran an article quoting Bob Debruyn, a Michigan onion farmer whose father had worked hard to create the original onion-futures ban: "I would think that a futures market for onions would make some sense today, even though my father was very much involved in getting rid of it." *What Onions Teach Us About Oil Prices,* Jon Birger, FORTUNE June 2008.

In hearing after hearing over the last few months, self-styled experts have offered personal, largely impromptu estimates of the contribution of speculation to the price of a barrel of crude oil. Many of these witnesses estimated $50 or $60 or more per barrel. Claims were made that additional regulation would immediately reduce oil prices by these amounts. None of these estimates, to my knowledge, were based upon or referenced any objectively published research backing such claims.

In one of the more egregious examples, Professor Michael Greenberger, a fellow witness on this panel, testified before the Senate Commerce Committee in June that prohibiting trading on electronic OTC oil markets would bring down the price of crude oil by 25 percent overnight. Despite the fact that there is little to no electronic trading of OTC crude oil in the U.S.; this and 28 other statements by Professor Greenberger caused the U.S. Permanent Subcommittee on Investigations to find his testimony so inaccurate and inflammatory that it felt compelled to issue a joint analysis prepared by both Majority and Minority staffs rebuking 29 statements.

In contrast to this rhetoric, thorough independent analyses of crude oil prices have been published by agencies such as the CFTC and the International Energy Administration. Neither found evidence pointing to excessive speculation or manipulation as the cause of high crude oil prices. Instead, the CFTC noted that long positions held by those often accused of excessive speculative buying, including noncommercials and swaps dealers, were actually flat to lower during the recent 12 month period in which the price of crude oil doubled. The recent IEA report concluded that there was little evidence that investment flows into futures markets were contributing to high oil prices, but rather the market was projecting that global demand would continue to outstrip global supply.

With no quick answers to supply and demand problems, focus has shifted to closing perceived regulatory loopholes. First there was the Enron loophole, which was, in fact, closed for all energy commodities including crude oil in the recently enacted farm bill legislation. Prompted by natural gas trading on electronic OTC platforms like ICE, Congress now requires that any electronically OTC energy swap that serves a significant price discovery function be regulated like a future. ICE's substantial obligations in this regard include, among other things, requirements to monitor trading, prevent manipulation, and enforce position or accountability limits, including the liquidation of open positions and suspension of trading.

The largest natural gas and electric power OTC markets on the ICE platform account for roughly 90 percent of our total electronic OTC volume. These key contracts are expected to be deemed significant price discovery contracts by the CFTC under the new law. We believe Congress and in particular this Committee showed great understanding in passing legislation that appropriately applied futures-style regulation on the small number of large OTC contracts and not the hundreds of illiquid OTC markets that constitute the last ten percent.

Now there is a renewed cry to reclose the already closed Enron loophole in an effort to lower crude oil prices. Ironically, with virtually no OTC trading in U.S. crude oil occurring on ICE or any other electronic OTC platform, it would be as impossible for this loophole to cause high crude oil prices as it would be for increased regulation of the same to lower them. The truth is that OTC trading of U.S. crude oil and refined products remains the exclusive domain of voice brokers and direct negotiation where ICE has no role.

A second loophole called the London loophole has been a more recent target for increased regulation. This debate focuses on ICE's wholly owned subsidiary, ICE Futures Europe. Founded in London 27 years ago as the International Petroleum Exchange and acquired by ICE in 2001, this market is a regulated exchange under the supervision of the U.K. Financial Services Authority, or FSA.

As the home of the ICE Brent crude and gasoil futures contracts, ICE Futures Europe has since its inception been the leading energy futures exchange in Europe. To complement its Brent crude contract, the exchange, in 2006, added a future that settles on the settlement price of the NYMEX WTI crude oil contract. Offering Brent and WTI contracts on the same platform allows commercial participants to hedge price differences between these two. NYMEX has since listed a Brent crude oil contract settling on the ICE Brent settlement price for the very same reason.

ICE Futures Europe provides access to traders in the U.S. as a foreign board of trade operating under a CFTC No Action letter issued in 1999 and amended several times since. In granting a No Action letter, the CFTC examines the foreign board of trade status in its home jurisdiction, and its rules and enforcement. Since Congress created this framework in 1982, the CFTC has granted no action relief to at least 20 foreign boards of trade. Other countries have reciprocal policies in place upon which U.S. exchanges like the CME, NYMEX and ICE Futures U.S. rely to offer access to their markets in over 50 jurisdictions around the world. Disregard for this mutual recognition system would impair the competitiveness of U.S. exchanges abroad and represent a major step back for global cooperation.

Consistent with this framework, ICE Futures Europe has shared WTI trader positions with the CFTC since the contract's launch. On June 17, the CFTC closed the so-called London loophole by modifying our No Action letter to require U.S. equivalent position limits and accountability levels as a reasoned condition for continued access to the ICE WTI contract by U.S. traders.

Though politically popular, closure of this loophole is unlikely to have any effect on crude oil prices. Most of the recent growth in trading of WTI crude oil has been on the NYMEX, not the ICE market. As a result, ICE has a relatively small 15 percent share of total WTI open interests, while NYMEX retains the remaining 85 percent. Such a small and, in fact, declining market share hardly seems evidence of a meaningful loophole.

In closing, we note that prices for virtually all agricultural and natural resource future contracts, as well as non-exchange-traded commodities such as iron ore and rice have surged at rates similar to crude oil and in some cases even more sharply and with greater volatility. Since none of these other commodities are known to fea-

ture electronic OTC platforms or foreign boards of trade offering cash-settled versions of U.S. contracts, it would seem that other more fundamental factors are to blame for all of these high commodity prices. Regardless, we look forward to working with Congress and the CFTC to ensure that all possible solutions to this crisis are explored.

Mr. Chairman, thank you for the opportunity.

[The prepared statement of Mr. Vice follows:]

PREPARED STATEMENT OF CHARLES A. VICE, PRESIDENT AND COO, INTERCONTINENTALEXCHANGE, INC., ATLANTA, GA

Chairman Peterson, Ranking Member Goodlatte, I am Chuck Vice, President and Chief Operating Officer of the IntercontinentalExchange, Inc., or "ICE." We very much appreciate the opportunity to appear before you today to give our views on the over-the-counter (OTC) energy markets

**Background**

ICE is a leading operator of global marketplaces with three regulated futures exchanges and an OTC marketplace offering a wide variety of contracts. As background, ICE was established in 2000 as an electronic OTC platform to serve the energy markets. ICE was established to bring transparency to OTC markets that were traded at that time through opaque OTC voice brokers or through the flawed "one-to-many" Enron On-Line trading model. In the Enron model, Enron served as both the marketplace for trading and the counterparty to every trade occurring in the market. In stark contrast, ICE sought to develop a neutral "many to many" marketplace, in which we, the operator, take no position in the market while enforcing strict best bid/best offer trading protocols. Trading volume on ICE's OTC markets is almost solely related to contracts for natural gas and power. Our electronic OTC platform has a 0% share of trading in U.S. crude oil, heating oil, jet fuel, and gasoline. ICE's electronic OTC markets have provided cost savings and efficiencies to participants while delivering an unprecedented level of OTC market transparency to both the Commodity Futures Trading Commission (CFTC) and the Federal Energy Regulatory Commission (FERC).

Since the launch of its electronic OTC energy marketplace in 2000, ICE has acquired and now operates three regulated futures exchanges through three separate subsidiaries, each with a separate governance and regulatory infrastructure. The International Petroleum Exchange (renamed ICE Futures Europe), was a 20 year old exchange specializing in energy futures when acquired by ICE in 2001. Located in London, it is a Recognized Investment Exchange, or RIE, operating under the supervision of the UK Financial Services Authority (FSA). In early 2007, ICE acquired the 137 year old "The Board of Trade of the City of New York" (renamed ICE Futures U.S.), a CFTC-regulated Designated Contract Market (DCM) headquartered in New York specializing in agricultural, foreign exchange, and equity index futures. In late 2007, ICE acquired the Winnipeg Commodity Exchange (renamed ICE Futures Canada), a 120 year old exchange specializing in agricultural futures, regulated by the Manitoba Securities Commission, and headquartered in Winnipeg, Manitoba.

**ICE Operates a Transparent OTC Marketplace**

Over-the-counter markets ranging from U.S. interest rate instruments to foreign exchange and debt securities are increasingly global and have migrated to electronic platforms due to their vast size and global nature As I mentioned, in 2000 ICE developed an electronic, many-to-many electronic marketplace for trading both physical energy commodities and financially-settled over-the-counter derivatives based on energy commodities. ICE in effect performs the same functions as "voice brokers" in the OTC market, but does so through a transparent electronic trading platform with strict trading protocols. Voice brokers offer limited transparency and tend to transact with only the largest trading firms, and continue to serve as the primary venue for OTC oil trading today. ICE's OTC model, though not active in U.S. crude oil, provides equal access to high quality information to all market participants, whether the smallest utility or the largest investment bank, primarily for natural gas and power. ICE's marketplace offers faster and more efficient trade execution while providing regulators with a comprehensive audit trail with respect to orders entered and transactions executed in the markets, none of which is available from voice brokers.

The development of ICE's OTC marketplace has also promoted competition and innovation in the energy derivatives market, to the benefit of both market participants and consumers. The increased liquidity offered by electronic trading has resulted in lower transaction costs and tighter bid/ask spreads, reducing the cost of hedging energy price risk and lowering operating costs for businesses. The reliability of ICE's markets has also resulted in an increasing preference for electronic trading in these markets. NYMEX, in its recent testimony before the Senate Permanent Subcommittee on Investigations (the "Senate PSI"), noted that 80–85% of its futures volume is now traded electronically, a development driven largely by competition from ICE. The CFTC also pointed out, in its Senate PSI testimony, that "the ability to manipulate prices on either [NYMEX or ICE] has likely been reduced, given that ICE has broadened participation in contracts for natural gas."

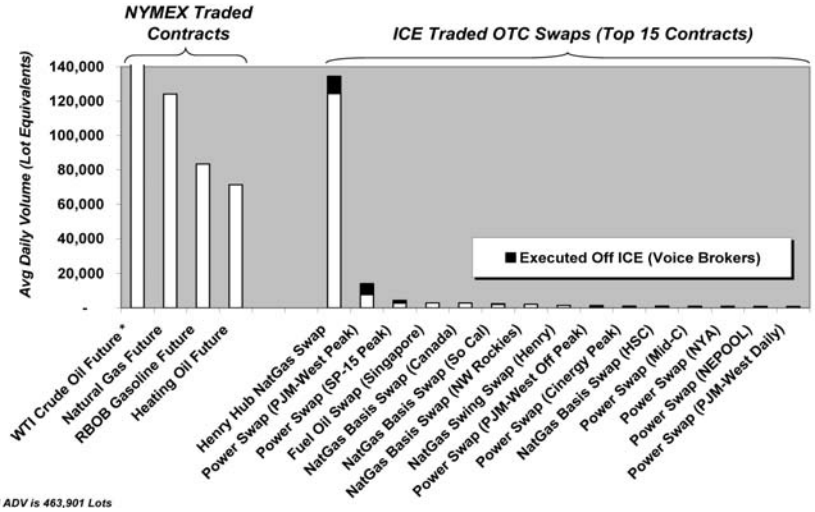
Like other electronic marketplaces, participants on ICE enter bids and offers electronically. Transactions are matched in accordance with an algorithm that executes transactions on the basis of time and price priority. Participants executing a transaction on our platform may settle the transaction in one of two ways—on a bilateral basis, settling the transaction directly between the two counterparties to the trade, or on a cleared basis through a clearinghouse using the services of a futures commission merchant that is a member of the clearinghouse.

It is important to note that there are substantial differences between ICE's OTC market, other portions of the OTC market, and the NYMEX futures market. These differences necessarily inform and guide the appropriate level of oversight and regulation of our markets. First, ICE is only one of many global venues on which market participants can execute OTC trades. A significant portion of OTC trading in natural gas continues to be executed through voice brokers or through direct bilateral negotiation between market counterparties. Of the available forums, only ICE (and any other similarly-situated ECM) is subject to CFTC jurisdiction and the CFTC's regulations, and to limitations on the nature of its participants.

Second, participants in a given futures market must become members of the relevant exchange or trade through a futures commission merchant that is a member. In contrast, ICE's OTC market, by law, is a "principals only" market in which participants must execute trades in their own names on the system. This market is designed solely for sophisticated participants, and participation in ICE OTC markets, unlike most other OTC venues is fully documented.

Third, the OTC market offers a substantially wider range of products than the futures markets, including, for example, hundreds of niche derivative contracts on natural gas and power at over 100 different delivery points in North America. The availability of these niche markets on ICE has improved transparency and lowered transaction costs via tighter bid-ask spreads, but volume nonetheless remains very low at most points. The market reality, for most of these illiquid points, is that participation is limited to the very small number of marketers, utilities, and others that have some intrinsic supply or demand interest in specific delivery points. Below is a chart[1] that compares the relative size of NYMEX traded futures contracts and ICE's largest electronic OTC energy markets.

[1] From the testimony of Jeffrey Sprecher, IntercontinentalExchange, Inc. CEO before the U.S. Senate Permanent Subcommittee on Investigations, June 25, 2007.




Fourth, the most liquid products traded in OTC markets broadly, and in the ICE OTC market specifically, are cash-settled derivatives contracts that require one party to pay to the other an amount determined by the final settlement price in the corresponding futures contracts. Such cash-settled swaps do not, and cannot, result in the physical delivery or transfer of energy commodities. These derivative contracts have been widely used by OTC energy market participants long before the creation of ICE. In fact, these contracts are useful and common in any market for which there are benchmark futures prices. Our Henry Hub natural gas swap, for example, constitutes an important commercial hedging vehicle and has served as an important complement to and as a hedge for the NYMEX Henry Hub natural gas futures contract. This same contract is now subject to the same futures-style regulation that applies to a DCM contract.

**Greater Oversight Over Exempt Commercial Markets (ECMs)**

As the OTC markets have grown and developed since passage of the Commodity Futures Modernization Act, new regulatory challenges have emerged. In May, as part of the farm bill, Congress, with strong bipartisan support, passed legislation providing the CFTC with greater oversight of electronic OTC markets, or ECMs. As a result of that new law, ECMs are now obligated to apply market oversight principles equivalent to those employed by fully regulated futures exchanges for larger OTC contracts that, like futures contracts, serve a significant price discovery function.[2]

As part of its new authority, the CFTC will determine whether contracts traded on ECMs serve a significant price discovery function, which broadly includes contracts that are linked to a futures exchange's contracts or which have independently been adopted by the marketplace as a price reference for the underlying energy commodity.

If the CFTC determines that an ICE contract serves a significant price discovery function, ICE will thereafter have self-regulatory responsibilities with respect to such contract similar to those of a DCM, or futures exchange. As a self regulatory organization, ICE will be required to discharge seven core principles, which cover all of the core principles discharged by futures markets other than those applicable to brokers and intermediated trades, which by law cannot occur in an ECM's markets. Specifically, the core principles state that the ECM shall:

- List only significant price discovery contracts that are not readily susceptible to market manipulation;
- Monitor trading in its significant price discovery contracts to prevent market manipulation;

[2] This provision of the farm bill is commonly referred to as the "Closing the Enron Loophole Act."

- Establish and enforce rules have the ability to obtain information to comply with the core principles;
- Adopt position limits or accountability limits;
- Adopt rules to give it the authority to liquidate open positions and suspend trading in significant price discovery contracts;
- Monitor and enforce compliance with its rules; and
- Establish and enforce rules to minimize conflicts of interest.

Importantly, as I will explain further, the legislation provides equivalent regulation for "futures like" OTC contracts, while avoiding unintended the consequence of driving trading in illiquid OTC contracts to the opaque, voice brokered parts of the OTC market. The CFTC has virtually no visibility into these OTC markets because they are not traded on an electronic platform like ICE.

**One Size of Regulation Does Not Fit All Markets or Contracts**

Even though Congress has increased the oversight and regulation of ECMs, some have argued that all contracts should be traded on a designated contract market. The problem with "one size fits all" regulation can best be illustrated by contrasting the historic nature of futures markets (limited number of actively traded benchmark contracts, all transactions executed through a broker who can trade for its own account or that of a retail customer) with the ECM OTC swaps markets (large number of niche products, many illiquid and thinly traded, principals only trading). Recognizing the importance of futures pricing benchmarks to the general public (a DCM is obligated to publish its prices to be used by the broader market), and in recognition of the potential for conflicts of interest due to members trading for their own accounts alongside business transacted on behalf of customers, some of whom were retail customers, DCM core principles were developed to facilitate regulation of the markets by the DCM, which acted as a self regulatory organization. The typical high level of liquidity in benchmark contracts make application of core principles such as market monitoring and position accountability and limits feasible and appropriate.

Suggesting that these same DCM core principles, which were developed with the futures exchange model in mind, should apply to all OTC swap contracts traded on an ECM market is attempting to fit the proverbial square peg in a round hole. Most of the energy swaps available on ICE are niche OTC products that trade in illiquid markets that are simply not amenable to the application of DCM core principles. For example, does it make sense to publish a real-time price feed for a market in which real-time bids and offers are rare and days pass between trades? Also, how would an ECM actively monitor an illiquid swaps market in an attempt to "prevent manipulation" where there may be few or no trades due to the limited liquidity in the market? How would an ECM swaps market administer accountability limits in a market that has only a handful of market participants? Should the ECM question when a single market participant holds 50% of the liquidity in an illiquid market when the market participant is one of the only providers of liquidity in the market?

It is important to analyze these questions not in isolation, but in the context of market participants having alternatives such as OTC voice brokers or overseas markets through which they can conduct their business. Importantly, such OTC voice brokers can even offer their customers the benefits of clearing through use of block clearing facilities offered by NYMEX and by ICE. Faced with constant inquiries or regular reporting by the ECM related to legitimate market activity, and facing no such monitoring when it transacts through a voice broker, market participants might choose to conduct their business where transparency and reporting requirements are non-existent. It is for these and other reasons that Congress and the Commission have developed the carefully calibrated three-tiered regulatory structure applicable to DCMs and ECMs. We believe that the judgments made by Congress and the CFTC thus far have been prudent and should be maintained.

**Conclusion**

In conclusion, ICE remains a strong proponent of open and competitive OTC markets and of appropriate regulatory oversight of those markets. The recently passed farm bill places a significantly higher level of regulation on electronic OTC energy platforms. In doing so, Congress appropriately recognized the importance of focusing on the relatively small number of larger OTC contracts that perform a significant price discovery function, rather than the hundreds or even thousands of OTC contracts that are rarely traded.

ICE recognizes the severe impact of high crude oil prices on the U.S. economy and understands the Congressional desire to "leave no stone unturned." However, since our electronic OTC platform has a 0% share of trading in U.S. crude oil, heating

oil, jet fuel, and gasoline, further regulation or even elimination of electronic OTC markets by Congress is certain to have no effect on oil prices. Such moves would, unfortunately, though, ensure that OTC oil trading continues to be executed by brokers over the telephone in a manner completely opaque to the marketplace and regulators.

Mr. Chairman, thank you for the opportunity to share our views. I would be happy to answer any questions you may have.

The CHAIRMAN. Thank you very much for making time to be with us.

Mr. Comstock.

**STATEMENT OF MICHAEL COMSTOCK, ACTING DIRECTOR, CITY OF MESA, ARIZONA GAS SYSTEM; VICE CHAIRMAN, BOARD OF DIRECTORS, AMERICAN PUBLIC GAS ASSOCIATION, MESA, AZ**

Mr. COMSTOCK. Chairman Peterson, Ranking Member Goodlatte and Members of the Committee, I appreciate this opportunity to testify before you today, and I thank the Committee for calling this hearing on the important subject of trading in the over-the-counter market.

My name is Michael Comstock, and I am the acting Director for the City of Mesa, Arizona, Gas System, a not-for-profit municipal utility. I also serve as the Vice Chair of the Board of Directors for the American Public Gas Association.

The City of Mesa provides natural gas, electric, water and wastewater service to its residents. We have provided gas service to our customers for over 90 years, and we currently serve approximately 53,000 homes and businesses.

I testify today on behalf of the American Public Gas Association. APGA is the national association for publicly owned not-for-profit natural gas retail distribution systems. There are approximately 1,000 public gas systems in 36 states, and over 700 of these systems are APGA members. Every Member of the Committee, with the exception of Congressman Walberg of Michigan, has public gas systems in their state.

There has understandably been a great deal of attention focused on the high price of gasoline during the summer driving season. APGA believes it is equally important to focus on the price of natural gas in advance of the winter heating season. This December, when natural gas customers open their heating bills, the commodity cost is expected to have doubled from last December. 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 record run-ups in the price of natural gas. If gasoline prices increased at the same rate as natural gas prices have increased over the last 10 years, drivers would now be paying more than $6.50 per gallon.

APGA's number one priority is the safe and reliable delivery of affordable natural gas. To bring natural gas prices 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 price 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, excessive speculative trading or other certain types of index trading strategies.

APGA would like to commend the Committee for its work on the recently enacted farm bill and for including the language to increase market transparency. Title VIII of the farm bill reauthorizes the Commodity Futures Trading Commission and includes language to increase the regulatory reporting and self-regulatory provisions relating to the unregulated energy trading platforms.

This language is a positive first step, but we also believe more needs to be done to increase transparency. For example, the over-the-counter market currently remains opaque to regulatory scrutiny. This lack of transparency is in a very large and rapidly growing segment of the natural gas market. It leaves open the potential for a participant 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.

Equally significant, even where the trading is not intended to be abusive, the lack of transparency for the overall energy market leaves regulators unable to answer questions regarding large speculators' possible impacts on the market.

It is APGA's position that additional transparency measures with respect to the transactions in the OTC markets are needed to enable CFTC to assemble a full picture of the trader's position and thereby understand the large trader's potential on the market. Additional transparency will also enable the CFTC to better detect and deter other types of market abuses. Including, for example, a company providing false price reporting information or a company engaging in watch trading by taking large offsetting positions with the intent to send misleading signals of supply and 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 including their bilateral OTC transaction. It would also enable the CFTC to better understand the overall size and speculative positions in the market as well as the impact of certain speculative investor practices or strategies on prices.

APGA commends this Committee for its focus on the possible impact the speculative investment has on the price of natural gas and other commodities. With energy prices at their current high levels, consumers certainly should not be forced to pay speculative premiums. To the extent that speculative investment may be increasing the price of natural gas or causing price aberrations; we strongly encourage Congress to take quick actions to expand market transparency in order to be able to responsibly address this issue and protect consumers from additional cost burdens.

Ultimately, in order to bring natural gas prices back to a long-term affordable level, our energy policy must ensure that supply is adequate to meet demand. This will require that supply and demand for natural gas be unfettered by regulation. Yet current statutory and regulatory policy, first, prohibit the assessment of offshore reserves; second, restrict and limit access to production in known area reserves; and third, encourage the use of natural gas for new electric generation. It makes no sense to encourage greater

use of natural gas on one hand while at the same time to impede the acquisition of data that could point to areas of abundant new resources and to obstruct production in areas of rich supplies. In light of these facts, it is a wonder that speculators find these markets attractive.

In addition to increasing transparency, APGA fully supports immediate increased funding for the CFTC. We believe that CFTC plays a pivotal role in protecting the American consumers; however, its funding and staffing levels have not kept pace with the complexity or scope of its job. We believe that this needs to be addressed by Congress.

Natural gas is the 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 that those consumers are paying for natural gas comes through the operation of fair and orderly markets, through appropriate market mechanisms that establish a fair and transparent marketplace.

APGA looks forward to working with the Committee to determine whether further enhancements are necessary to restore consumer confidence in the integrity of the markets price discovery mechanism.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Comstock follows:]

PREPARED STATEMENT OF MICHAEL COMSTOCK, ACTING DIRECTOR, CITY OF MESA, ARIZONA GAS SYSTEM; VICE CHAIRMAN, BOARD OF DIRECTORS, AMERICAN PUBLIC GAS ASSOCIATION, MESA, AZ

Chairman Peterson, Ranking Member Goodlatte and Members of the Committee, I appreciate this opportunity to testify before you today and I thank the Committee for calling this hearing on the important subject of trading in the over-the-counter (OTC) market. My name is name is Michael Comstock and I am the Acting Director for the City of Mesa, Arizona Gas System. I also serve as Vice Chair of the Board of Directors for the American Public Gas Association (APGA).

The City of Mesa provides natural gas, electric, water and wastewater service to its residents. We have provided gas service to our customers for over 90 years and we currently serve approximately 53,000 homes and businesses throughout Mesa and portions of Pinal County. Strong growth in the region has made Mesa one of the fastest-growing and respected municipal gas utilities in the United States.

I testify today on behalf of the 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 over 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. Every Member of the Committee, with the exception of Congressman Walberg of Michigan, has public gas systems in their state.

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, other abusive market conduct or excessive speculation.

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. APGA has strongly supported an increase in the level of transparency with respect to trading activity in these markets from that which currently exists. We believe that additional steps are needed in order to restore our current lack of confidence in the natural gas marketplace and to provide sufficient transparency to enable the CFTC, and market users, to form a reasoned response to the critically im-

portant questions that have been raised before this Committee during the course of these hearings.

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 has become law. We commend this Committee for its work on the CFTC reauthorization bill. The market transparency language that was included in the farm bill will help shed light on whether market prices in significant price discovery energy contracts are responding to legitimate forces of supply and demand or to other, non-*bona fide* market forces. APGA believes that more can, and should, be done to further increase transparency of trading in the energy markets. Many of these steps would likely also be useful in better understanding the current pricing trends in the markets for other physical commodities as well.

APGA believes that these additional steps, a number of which the CFTC has undertaken through administrative action, have the potential either directly to address the concerns APGA has raised with respect to lack of transparency in these markets, or to provide needed information so that a consensus can be reached on the additional statutory or regulatory steps, if any, that should be taken to responsibly and effectively address the questions that have been raised regarding the potentially adverse effects on these markets resulting from excessive speculative trading.

Although the additional authorities which have been provided to the CFTC under Title XIII of the 2008 Farm Bill will provide the CFTC with significant additional tools to respond to the issues raised by this hearing (at least with respect to the energy markets), we nevertheless believe that it may be necessary for Congress to provide the CFTC with additional statutory authorities. We are doubtful that the initial steps taken by the reauthorization legislation are, or will be, sufficient to fully respond to the concerns that we have raised regarding the need for increased transparency. In this regard, we believe that additional transparency measures with respect to transactions in the over-the-counter markets are needed to enable the cop on the beat to assemble a full picture of a trader's position and thereby understand a large trader's potential impact on the market.

We further believe, that 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, that Congress should be prepared to take additional legislative action to further improve transparency with respect to trading in energy contracts and, should the case be made, to make additional amendments to the Commodity Exchange Act, 7 U.S.C. § 1 et seq. ("Act"), to make changes in the administration of speculative position limits in order to ensure the integrity of the energy markets.

**History of Regulation Under the Commodity Exchange Act**

Systemized trading in contracts for the future delivery of agricultural commodities developed in the United States in the mid to late 1800s from an economic need for risk shifting. Glaring abuses were attendant with the advantages of trading, these included price manipulations, market corners and extreme and sudden price fluctuations on the organized exchanges. These abuses stirred repeated demands for legislative action to prohibit or comprehensively regulate futures trading. Although the first regulation of the grain futures markets dates from the 1920's,[1] the Commodity Exchange Act of 1936[2] was the first statute to comprehensively regulate the futures markets.

Section 3 of the Act as it existed before to the 2000 amendments explained the statute's purpose in relevant part as follows:

> Transactions in commodities involving the sale thereof for future delivery as commonly conducted on boards of trade and known as "futures" are affected with a national public interest. Such futures transactions are carried on in large volume by the public generally and by persons engaged in the business of buying and selling commodities and the products and byproducts thereof . . . The prices involved in such transactions are generally quoted and disseminated through the United States and in foreign countries as a basis for determining the prices to the producer and the consumer . . . The transactions and prices of commodities on such boards of trade are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed, to the detriment of the producer or the consumer . . .

[1] See, Grain Futures Act of 1922, Pub. L. No. 6–331, 42 Stat. 998 (1922).
[2] Act of June 15, 1936, ch. 545 § 5, 49 Stat 1494.

Section 4a(a) of the Act echoes the Congressional finding of former section 3, providing that, "Excessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract mar kets . . . causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity." 7 U.S.C. § 6a.

The CFTC in 1981 adopted a rule requiring all futures exchanges to impose speculative position limits for all commodities that were not subject to a Federal speculative position limit.[3] In so doing, the Commission explained the danger that unchecked speculative positions can pose to the markets, saying:

> It appears that the capacity of any contract market to absorb the establishment and liquidation of large speculative positions in an orderly manner is related to the relative size of such positions, *i.e.,* the capacity of the market is not unlimited. Recent events in the silver market would support a finding that the capacity of a liquid futures market to absorb large speculative positions is not unlimited, notwithstanding mitigating characteristics of the underlying cash market.

"Establishment of Speculative Position Limits," 46 *Fed. Reg.* 50938, 509040 (October 16, 1981).

The CFTC's conclusion in 1981 was that the ability of liquid markets to absorb excessively large speculative positions without suffering from artificial upward pressure on prices is not unlimited, and based on that reasoning, required exchanges to adopt speculative position limits for all contracts. That question, whether liquid markets have the ability to absorb excessively large speculative positions without suffering from artificial upward price pressure is the same question that is before this Committee today.

**Speculators' Effect on the Natural Gas Market**

As hedgers that use both the regulated futures markets and the OTC energy markets, we value the role of speculators in the markets. We also value the different needs served by the regulated futures markets and the more tailored OTC 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 Committee on Investigations affirmed that "Amaranth's massive trading distorted natural gas prices and increased price volatility."[4]

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[3] The Commission subsequently modified this requirement, permitting contract markets to impose "position accountability rules" *in lieu of* speculative position limits for certain contracts, including the energy contracts.

[4] *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.

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 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.

Recently, additional concerns have been raised with respect to the size of positions related to, and the role of, passively managed long-only index funds. In this instance, the concern is not whether the positions are being taken in order to intentionally drive the price higher, but rather whether the unintended effect of the cumulative size of these positions has been to push market prices higher than the fundamental supply and demand situation would justify.

The additional concern has been raised that recent increased amounts of speculative investment in the futures markets generally have resulted in excessively large speculative positions being taken that due merely to their size, and not based on any intent of the traders, are putting upward pressure on prices. The argument made is that these additional inflows of speculative capital are creating greater demand then the market can absorb, thereby increasing buy-side pressure which results in advancing prices.

Some have responded to these concerns by reasoning that new futures contracts are capable of being created without the limitation of having to have the commodity physically available for delivery. This explains why, although the open-interest of futures markets can exceed the size of the deliverable supply of the physical commodity underlying the contract, the price of the contract could nevertheless reflect the forces of supply and demand.

APGA commends this Committee for its focus on the possible impact speculative investment has on the price of natural gas and other energy commodities and for asking these tough questions. With energy prices at their current high levels, consumers should not be forced to pay a "speculative premium." However, APGA is not in a position to determine which of the above two views is correct. More significantly and profoundly disturbing, because of limitations with respect to transparency of trading in these markets, the data and facts are unavailable that would enable market observers, including both the regulators and the public, to make a reasoned judgment about this issue.

As we noted above, as hedgers we rely on speculative traders to provide liquidity and depth to the markets. Thus, we do not wish to see steps taken that would discourage speculators from participating in these markets using *bona fide* trading strategies. But more importantly, APGA's members rely upon the prices generated by the futures to accurately reflect the true value of natural gas. Accordingly, APGA would support additional regulatory controls, such as stronger speculative position limits, if a reasoned judgment can be made based on currently available, or additional forthcoming market data and facts, that such controls are necessary to address the unintended consequences arising from certain speculative trading strategies or to reign in excessively large speculative positions. To the extent that speculative investment may be increasing the price of natural gas or causing pricing aberrations, we strongly encourage Congress to take quick action to expand market transparency in order to be able to responsibly address this issue and protect consumers from additional cost burdens.

**The Markets 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, such as the IntercontinentalExchange ("ICE"). ICE also operates an electronic trading platform for trading non-cleared (bilateral) OTC contracts. They may also be traded in direct, bilateral 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.[5] However, any failure of the futures price to reflect fundamental supply and demand conditions results in prices for natural gas that are distorted and which do not reflect its true value.[6] 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 consumers pay for the fuel needed to heat their homes 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. And under the provisions of the Title XIII of the farm bill, the CFTC has been given additional regulatory authority with respect to significant price discovery contracts traded on exempt commercial markets, such as ICE. This is indeed a major step toward greater market transparency. However, even with this additional level of transparency, a large part of the market remains opaque to regulatory scrutiny. 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 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.

Equally significant, even where the trading is not intended to be abusive, the lack of transparency for the over-all energy markets leaves regulators unable to answer questions regarding speculators' possible impacts on the market. For example, do we know who the largest traders are in the over-all market, looking at regulated futures contracts, significant price discovery contracts and bilateral OTC transactions? Without being able to see a large trader's entire position, it is possible that the effect of a large OTC trader on the regulated markets is masked, particularly when that trader is counterparty to a number of swaps dealers that in turn take positions in the futures market to hedge these OTC exposures as their own.

**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/noncommercial) and their concentration in the market, including the percentage of the total positions held by each category of trader (commercial/noncommercial).

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

[5] *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." A further question with respect to whether other speculative strategies, or excessively large speculative positions is also distorting market prices by pushing prices higher than they otherwise would be.

[6] The effect of Amarath's trading resulted in such price distortions. *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."

expiring future and the next delivery month is reflective of the underlying supply and demand conditions in the cash market.[7]

Title XIII of the farm bill, recently empowered the CFTC to collect large trader information with respect to "significant price discovery contracts" traded on the ICE trading platform. However, there remain significant gaps in transparency with respect to trading of OTC energy contracts, including many forms of contracts traded on ICE. 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. More profoundly, it leaves the regulator unable to assemble a true picture of the over-all size of a speculator's position in a particular commodity.

**Greater Transparency Needed**

Our members, and the customers served by them, believe that although Title XIII of the farm bill goes a long way to addressing the issue, there is not yet 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 positions taken in only one, or two, segments of the total market. Without comprehensive large trader position reporting, the government will remain handicapped in its ability to detect and deter market misconduct or to understand the ramifications for the market arising from unintended consequences associated with excessive large positions or with certain speculative strategies. 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. Similarly, we simply do not have the information to analyze the over-all effect on the markets from the current practices of speculative traders.

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 bilateral 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, but recognizes that more needs to be done to address this issue comprehensively.

**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.[8] 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. It would also enable the CFTC to better understand the overall size of speculative positions in the market as well as the impact of certain speculative investor practices or strategies on the future's markets ability to accurately reflect fundamental supply and demand conditions.

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

[8] *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.

Accordingly, APGA supports proposals to further increase and enhance transparency in the energy markets, generally, and in the markets for natural gas, specifically. APGA supports greater transparency with respect to positions in natural gas financial contracts acquired through bilateral transactions. Because bilateral trading can in fact be conducted on an all-electronic venue, and can impact prices on the exchanges even if conducted in a non-electronic environment, it is APGA's position that transparency in the bilateral markets is critical to ensure an appropriate level of consumer protection.

**Electronic Ti-lateral trading**

One example of the conduct of bilateral trading on an all-electronic trading platform was "Enron On-line." Enron, using its popular electronic trading platform, offered to buy or sell contracts as the universal counterparty to all other traders using this electronic trading system. This one-to-many model constitutes a dealer's market and is a form of bilateral trading. This stands in contrast to a many-to-many model which is recognized as a multi-lateral trading venue. This understanding is reflected in section 1a(33) of the Commodity Exchange Act, which defines "Trading Facility" as a "group of persons that . . . provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts or transactions by accepting bids and offers made by other participants that are open to multiple participants in the facility or system." On the Enron On-line trading platform, only one participant—Enron—had the ability to accept bids and offers of the multiple participants—its customers—on the trading platform.

Section1a(3) continues by providing that, "the term 'trading facility' does not include (i) a person or group of persons solely because the person or group of persons constitutes, maintains, or provides an electronic facility or system that enables participants to negotiate the terms of and enter into bilateral transactions as a result of communications exchanged by the parties and not from interaction of multiple bids and multiple offers within a predetermined, nondiscretionary automated trade matching and execution algorithm . . . ." This means that it is also possible to design an electronic platform for bilateral trading whereby multiple parties display their bids and offers which are open to acceptance by multiple parties, so long as the consummation of the transaction is not made automatically by a matching engine.

Both of these examples of bilateral electronic trading platforms might very well qualify for exemption under the current language of sections 2(g) and 2(h)(1) of the Commodity Exchange Act. To the extent that these examples of electronic bilateral trading platforms were considered by traders to be a superior means of conducting bilateral trading over voice brokerage or the telephonic call-around markets, or will not fall within the significant price discovery contract requirements, their use as a substitute for a more-regulated exempt commercial market under section 2(h)(3) of the Act should not be readily discounted.

**Non-Electronic Bilateral Trading**

Moreover, even if bilateral transactions are not effected on an electronic trading platform, it is nonetheless possible for such direct or voice-brokered trading to affect prices in the natural gas markets. For example, a large hedge fund may trade bilaterally with a number of counterparty/dealers using standard ISDA documentation. By using multiple counterparties over an extended period of time, it would be possible for the hedge fund to establish very large positions with each of the dealer/counterparties. Each dealer in turn would enter into transactions on NYMEX to offset the risk arising from the bilateral transactions into which it has entered with the hedge fund. In this way, the hedge fund's total position would come to be reflected in the futures market. Thus, a prolonged wave of buying by a hedge fund, even through bilateral direct or voice-brokered OTC transactions, can be translated into upward price pressure on the futures exchange.

As NYMEX settlement approaches, the hedge fund's bilateral purchases with multiple dealer/counterparties would maintain or increase upward pressure on prices. By spreading its trading through multiple counterparties, the hedge fund's purchases would attract little attention and escape detection by either NYMEX or the CFTC. In the absence of routine large-trader reporting of bilateral transactions, the CFTC will only see the various dealers' exchange positions and have no way of tying them back to purchases by a single hedge fund.

Given that the various segments of the financial markets that price natural gas are linked economically, it is critical to achieving market transparency that traders holding large positions entered into through bilateral transactions be included in any large-trader reporting requirement. As explained above, by trading through multiple dealers, a large hedge fund would be able to exert pressure on exchange

prices similar to the pressure that it could exert by holding those positions directly. Only a large-trader reporting system that includes positions entered into in the OTC bilateral markets would enable the CFTC to see the entire picture and trace such positions back to a single source.

If large trader reporting requirements apply only to positions acquired on multilateral electronic trading platforms, traders in order to avoid those reporting requirements may very well move more transactions to electronic bilateral markets or increase their direct bilateral trading. This would certainly run counter to efforts by Congress to increase transparency. APGA remains convinced that all segments of the natural gas marketplace should be treated equally in terms of reporting requirements. To do otherwise leaves open the possibility that dark markets on which potential market abuses could go undetected would persist and that our current lack of sufficient information to fully understand the impact of large speculative traders and certain trading strategies on the markets will continue, thereby continuing to place consumers at risk.

**Better Categorizing of Positions and Administration of Hedge Exemptions**

APGA also notes that it has advocated that the CFTC take additional steps within its existing authorities to increase transparency, particularly with respect to the categorization of trades as speculative or not.[9] The CFTC uses the information derived from its large trader reporting system both for its internal analyses of the markets as well as providing the public with certain aggregated information in its weekly "Commitments of Traders reports." For purposes of this report, it classifies traders as "commercials" or "noncommercials." It is assumed that commercial traders are hedging in the markets and that noncommercials are speculators.

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. The CFTC recently announced that it was extending this initiative to include information relating to the crude oil markets. APGA is encouraged that the CFTC has taken steps to expand these enhancements to their Commitment of Traders Reports to include the crude oil contracts.[10] APGA believes that it is critical that this initiative include all physical commodities, and in particular, all energy-related commodities. Enhanced transparency with respect to large traders and the size, scope and composition of their aggregate positions will improve our understanding of the dynamics of the market at any particular time, potentially increasing hedger's confidence in the markets' price discovery function.

The CFTC has also announced an initiative to examine the classification of swaps dealers under the large trader reporting system. The example discussed above of a speculative trader entering into a bilateral transaction with a swaps dealer that then covers its position in the regulated futures market illustrates why this reclassification initiative is important to a full understanding of the impact of speculators on the markets. Prior to the CFTC's initiative, positions that were assumed for speculative purposes in the OTC markets apparently could be reflected in the CFTC's futures market reporting system as the positions of a "commercial." This happens because the swaps dealer may be covering its exposure in the futures market arising from its OTC position as counter-party to a bilateral OTC transaction. This was classified as a 'hedge' of the OTC position by the 'commercial' swaps dealer. However, the original OTC position may have been entered into for speculative purposes, by a hedge fund, for example. Accordingly, despite the economic linkage between the speculative OTC transaction and the regulated market, prior to the CFTC's recent re-classification initiative, speculative OTC positions have been reflected in the CFTC's COT futures market reports as non-speculative, "commercial" positions. Similarly, when a long-only index fund enters into a speculative OTC position with a swaps dealer, the position of the swaps-dealer in the futures market has been classified by the CFTC as the non-speculative position of a "commercial."

Equally profound, speculative position limits do not apply to hedging activity by commercials. Thus, positions that would be subject to a speculative position limit if entered into directly on the regulated exchange are not so limited if the speculator enters into the transaction in the OTC market and the swaps dealer in turn covers

[9] 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 bilateral 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.

[10] See, "Recent Energy Initiatives," CFTC Statement, *http://cftc.gov/stellent/groups/public/@newsroom/documents/file/cftcenergyinitiatives061708.pdf.*

its ensuing risk in the regulated market. In this way a speculator can amass a larger position indirectly than it could by trading directly on the exchange. The CFTC has also granted a number of staff No Action letters exempting from speculative position limits certain passively managed long-only index funds that have price exposure from their obligation to track a commodity index.[11]

Part of the increased transparency that APGA has been seeking includes a more nuanced approach to classification of positions so that the impact of these OTC speculative positions on the regulated market can be better understood. As noted above, the CFTC has recently undertaken several initiatives to report more accurately the trading of index funds and to better classify trading by swaps dealers. APGA believes that these are important initiatives that will shed greater light and understanding on the possible effects on the oil market arising from speculative traders and from certain speculative trading strategies.

It may be, however, that additional statutory changes would be helpful in ensuring that the CFTC has sufficient authority and direction to deepen and make permanent these steps and to apply them with respect to all physical commodities, including all energy-related products. APGA believes that although the issues discussed at this hearing arise most acutely in today's oil markets, the issues apply equally to all energy markets, including in particular natural gas. The problems that are being noted in relation to the oil markets have also been raised quite recently with respect to the natural gas markets and have been noted in respect to the market for propane. APGA believes that the problems that have been noted by this Committee are broader than the oil markets and that other energy markets, including natural gas, require continuing rigorous oversight and close attention.

**CFTC Resources**

The CFTC plays a critical role in protecting consumers, and the market as a whole, from fraud, manipulation and market distortion. It is essential that the CFTC have the necessary resources to monitor markets and protect consumers from attempts to manipulate the market. This is critical given the additional oversight responsibilities the CFTC will have through the market transparency language included in the farm bill and the additional transparency requirements that APGA is proposing to the Committee.

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. American consumers expect more than this form of regulatory triage.

**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 abuse markets or to address those that might innocently distort 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. Nor is it acceptable to be unable to make responsible public policy decisions because of a lack of transparency in the markets.

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 or market distorting 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 the extent to which the pricing mechanisms in the natural gas market today are reflecting market fundamentals or the possible market effects of various speculative trading strat-

[11] *See* CFTC Letter 06–09 (April 19, 2006); CFTC Letter 06–19 (September 6, 2006).

egies. However, we know that the confidence that our members once had in the pricing integrity of the markets has been badly shaken.

In order to protect consumers the CFTC must be able 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 704 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 the further enhancements that may be necessary to restore consumer confidence in the integrity of the price discovery mechanism.

In addition to increasing market transparency, however, if we are to bring natural gas prices back to an affordable level, it is equally important that energy policy must ensure that supply is adequate to meet demand. In addition to greater transparency in market pricing, this will require that supply and demand for natural gas be unfettered by regulation. Yet, current statutory and regulatory policies (1) prohibit the assessment of offshore reserves; (2) restrict and limit access to production in areas of known reserves; and (3) encourage the use of natural gas for new electric generation.

It makes no sense to encourage greater use of natural gas on the one hand while at the same time to impede the acquisition of data that could point to areas of abundant new resources and to obstruct production in areas with rich supplies. In light of these facts, is it a wonder that speculators find these markets attractive?

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, orderly and transparent markets. It is equally critical that regulatory policy support bringing demand and supply into balance. Every winter, more than 65 million residential and commercial homes and businesses are heated by natural gas. More than 20% of our nation's electricity is generated by natural gas, and that percentage will grow because America is unwilling to adopt 21st century nuclear technology and other alternatives to replace coal for electric generation. Increases in market transparency alone will not address this problem.

The CHAIRMAN. Thank you, Mr. Comstock.

Mr. Greenberger, welcome to the Committee.

**STATEMENT OF MICHAEL GREENBERGER, J.D., PROFESSOR, UNIVERSITY OF MARYLAND SCHOOL OF LAW, BALTIMORE, MD**

Mr. GREENBERGER. Thank you, Mr. Chairman. It is a pleasure to be here. This testimony is my own personal view about, and when I say personal, I emphasize personal. I represent nobody. I am here on my own behalf. I have no clients that I am representing, as my disclosure form makes clear.

I think the fundamental question this Committee has to answer is whether the purpose of the Commodity Exchange Act, which was established most clearly in 1936 to bar excessive speculation, is still an active purpose of the statute. In the 1935 report of this Committee that brought forth the Commodity Exchange Act, it was said, "The fundamental purpose of the measure is to ensure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity which too often demoralize the markets to the injury of producers and consumers and the exchanges themselves."

President Roosevelt, in a message to Congress urging the passage of what became the Commodity Exchange Act, said, "It should be our national policy to restrict as far as possible the use of these exchanges for purely speculative operations."

This bill authorizes the Commission to fix limitations on purely speculative trades. There is a lot of talk in the air about the speculative impacts on the price of crude oil. I am not an economist. I

have read a lot of economic studies about this and statements. What I will say is I think you cannot gainsay the fact that there is a dispute here of whether or not speculation is playing a role.

When the Commodity Exchange Act was passed in 1936, it was in response to farmers who, looking out at their fields, said, "I don't really have any control over what I am growing. Those guys back in Chicago, the locals," that is what they were called, the speculators, "control the price of what I am growing." And there is a 1892 report of this Committee that articulates a quote from a farmer with that very point. And the thesis was that those guys in Chicago, because that is where the trading was, could, by buying paper, paper trades, could raise and lower the price of this at their will.

Now, did the Commodity Exchange Act bar speculation? No, it did not. It recognized that speculators are needed to make a liquid exchange. But it did bar excessive speculation, and that excessive speculation has been fought with many tools, the most clearest of which, especially today in the agricultural market, are hard and fixed limits on the participation of speculators. In the OTC market, or in the foreign board of trade market as it stands today, there are real issues about whether those limits on speculators are working or whether they are even in place.

I don't believe it is the burden of the truckers, the airlines, the farmers, the automobile manufacturers to prove that there is no speculation. I believe that if it is in question, there needs to be the appropriate transparency to answer once and for all whether or not speculation is dominating these markets.

If you try and trace the $260 billion which has entered into the index swaps market since 2004, you can't go and find where the money is. You can't trace that money. Why? Because these markets are opaque. The same problem in the housing meltdown. You have credit default swaps which were deregulated by the Commodity Futures Modernization Act of 2000. The Chairman of the Fed would love to know what the total scope of those credit default swaps are, but they are buried all over the economy, and they only come to light upon a bankruptcy or some other transaction where they have to be fixed. You will note that the Chairman of the Fed is now saying if a financial institution, another major financial institution, fails, he does not want it to go through a bankruptcy proceeding.

My view is that the legislative proposals, and I am happy to talk about them in detail, would provide the transparency to answer, once and for all, is the price of oil supply and demand entirely, or, as many, many people have said, is there a speculative premium being added?

I want to emphasize two final things. I do not argue that the entire run-up of the price of crude oil or other commodities including agricultural prices is entirely speculation. What I do argue is if there is any part of it that is due to excessive speculation, not manipulation, but excessive speculation, we should put a stop to it. If it reduces gas prices by four percent, five percent, whatever, the American consumer should not be paying that speculative tax. If there is no speculation, then we can all go and say the argument is over.

One final point. Mr. Vice raised the analysis of my June 3 testimony before the Senate Commerce Committee. That analysis is not on their website. I am perfectly prepared to answer, under oath, any of the comments that were made in that analysis, and the Chairman of this Committee has asked that I provide him a letter doing so, which I have done. I sense from the Senate side that this is not something that they want to make into a public debate, as evidenced by the fact it is not on their website. And I am prepared to tamp that down, but if I need to defend myself, I will defend myself. I have written a detailed letter to the Chairman on it point for point, and not only do I believe I have not said anything in error, I believe that that analysis is filled with errors.

Thank you.

[The prepared statement of Mr. Greenberger follows:]

PREPARED STATEMENT FOR JULY 10 AND 11 OF MICHAEL GREENBERGER, J.D., PROFESSOR, UNIVERSITY OF MARYLAND SCHOOL OF LAW, BALTIMORE, MD

**Introduction**

My name is Michael Greenberger.

I want to thank the Committee for inviting me to testify on the important issue that is the subject of today's hearings.

After 25 years in private legal practice, I served as the Director of the Division of Trading and Markets ("T&M") at the Commodity Futures Trading Commission ("CFTC") from September 1997 to September 1999. In that capacity, I supervised approximately 135 CFTC personnel in CFTC offices in DC, New York, Chicago, and Minneapolis, including lawyers and accountants who were engaged in overseeing the Nation's futures exchanges. During my tenure at the CFTC, I worked extensively on, *inter alia*, regulatory issues concerning exchange traded energy derivatives, the legal status of over-the-counter ("OTC") energy derivatives, and the CFTC authorization of trading of foreign exchange derivative products on computer terminals in the United States.

While at the CFTC, I also served on the Steering Committee of the President's Working Group on Financial Markets ("PWG"). In that capacity, I drafted, or oversaw the drafting of, portions of the April 1999 PWG Report entitled "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," which recommended to Congress regulatory actions to be taken in the wake of the near collapse of the Long Term Capital Management (LTCM) hedge fund, including Appendix C to that report which outlined the CFTC's role in responding to that near collapse. As a member of the International Organization of Securities Commissions' ("IOSCO") Hedge Fund Task Force, I also participated in the drafting of the November 1999 report of IOSCO's Technical Committee relating to the LTCM episode: "Hedge Funds and Other Highly Leveraged Institutions."

After a 2 year stint between 1999 and 2001 as the Principal Deputy Associate Attorney General in the U.S. Department of Justice, I began service as a Professor at the University of Maryland School of Law. At the law school, I have, *inter alia,* focused my attention on futures and OTC derivatives trading, including academic writing and speaking on these subjects. I currently teach a course that I designed entitled "Futures, Options, and Derivatives."

The question whether there has been excessive speculation of U.S. energy futures markets in general, and futures based on U.S. delivered crude oil contracts specifically, has been the subject of many hearings. I have previously testified at six of those hearings, the most recent held on June 24, 2008 before the United States Senate Committee on Homeland Security & Government Affairs. To put the issue of this Committee's hearings in context, I summarize and update the points I made at that hearing immediately below.

**Summary and Update of Prior Testimony**

One of the fundamental purposes of futures contracts is to provide price discovery in the "cash" or "spot" markets.[1] Those selling or buying commodities in the "spot"

[1] *The Economic Purpose of Futures Markets and How They Work,* COMMODITY FUTURES TRADING COMMISSION, *http://www.cftc.gov/educationcenter/economicpurpose.html* (last visited July 8, 2008).

markets rely on futures prices to judge amounts to charge or pay for the delivery of a commodity.[2] Since their creation in the agricultural context decades ago, it has been widely understood that, unless properly regulated, futures markets are easily subject to distorting the economic fundamentals of price discovery (*i.e.,* cause the paying of unnecessarily higher or lower prices) through excessive speculation, fraud, or manipulation.[3]

As the 1935 Report of this Committee stated: "The fundamental purpose of the measure [*i.e.,* what was to become the Commodity Exchange Act of 1936 ('CEA')] is to insure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity which too often demoralize the markets to the injury of producers and consumers and the exchanges themselves."[4]

Indeed, President Roosevelt, when introducing what became the CEA said: "[I]t should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations."[5] In this regard, this Committee then stated: "This bill authorizes the Commission . . . to fix limitations upon purely speculative trades . . ."[6]

The CEA has long been judged to effectively prevent excessive speculation and manipulation. Accordingly, prior to the passage of the Commodity Futures Modernization Act of 2000 ("CFMA"), "all futures activity [was] confined by law (and eventually to criminal activity) to [CFTC regulated] exchanges alone."[7] At the behest of Enron, the CFMA authorized the "stunning"[8] change to the CEA to allow the option of trading energy commodities on deregulated trading platforms, *i.e.,* exchanges exempt from CFTC contract market registration requirements, thereby rejecting the contrary 1999 advice of the President's Working Group on Financial Markets, which included the Secretary of the Treasury, the Chairman of the Federal Reserve Board, and the Chairmen of the SEC and CFTC.[9] This exemption from contract market regulation is called the "Enron Loophole."

Two prominent and detailed bipartisan studies by the Permanent Subcommittee on Investigations' ("PSI")[10] staff concluded that large financial institutions and wealthy investors had needlessly driven up the price of energy commodities over what economic fundamentals dictate, adding, for example, what the PSI estimated to be @ $20–$25 per barrel to the price of a barrel of crude oil.[11] At the time of that estimate, the price of crude oil had reached a then record high of $77. The conclusion that excessive speculation has added a considerable premium to energy

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[2] See Platts Oil Pricing and Market-on-Close Methodology Explained, Platts (July 2007) at 3, available at *http://www.platts.com/Resources/whitepapers/index.xml.*

[3] *See, e.g.,* Jonathan Ira Levy, *Contemplating Delivery: Futures Trading and the Problem of Commodity Exchange in the United States,* 1875–1905, AMERICAN HISTORICAL REVIEW 307 (2006) ("'[T]he man who managed or sold or owned those immense wheat fields has not as much to say with the regard to the price of the wheat that some young fellow who stands howling around the Chicago wheat pit could actually sell in a day'"(quoting *Fictitious Dealings in Agricultural Products: House Comm. on Agric. Committee Hearing Reports* (1892)).

[4] Report No. 421, U.S. House of Representatives 74th Cong, Accompanying the Commodity Exchange Act, March 18, 1935.

[5] President Franklin D. Roosevelt, Message to Congress, February 9, 1934.

[6] Report No. 421, U.S. House of Representatives 74th Cong., Accompanying the Commodity Exchange Act, March 18, 1935.

[7] PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION 28 (Cumm. Supp. 2008).

[8] *Id.* at § 1.17.

[9] *Id.* at 28; *see also* President's Working Group on Financial Markets, Over-the-Counter Derivatives Markets and the Commodity Exchange Act 16 (1999), available at *http://www.ustreas.gov/press/releases/reports/otcact.pdf* (last visited July 8, 2008) ("Due to the characteristics of markets for non-financial commodities with finite supplies, however, the Working Group is unanimously recommending that the exclusion [from regulation] not be extended to agreements involving such commodities.").

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

[11] June 2006 Report, *supra* note 10, at 2, 23.

products has been corroborated by many experts on,[12] and observers of, these markets.[13]

The PSI staff and others have identified the Intercontinental Exchange ("ICE") of Atlanta, Georgia, as an unregulated trading facility upon which a considerable amount of exempt U.S. energy futures trading is done.[14] For purposes of facilitating exempt natural gas futures, ICE is deemed a U.S. "exempt commercial market" under the Enron Loophole.[15] For purposes of its facilitating U.S. WTI crude oil futures on U.S. trading terminals, the CFTC, by informal staff action, considers ICE, because of its wholly owned subsidiary, ICE Futures Europe, to be a U.K. entity not subject to direct CFTC regulation even though ICE maintains U.S. headquarters and U.S. trading infrastructure (*i.e.,* terminals and servers), facilitating, *inter alia,* @ 30% of trades in U.S. WTI futures trades.[16]

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[12] *See, e.g.,* Edmund Conway, George Soros: *Rocketing Oil Price is a Bubble,* DAILY TELEGRAPH (May 27, 2008), available at *http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2008/05/26/cnsoros126.xml* (last visited July 8, 2008) (quoting Mr. George Soros as stating "Speculation . . . is increasingly affecting the price"); Written Testimony of Michael Masters, Hearing Before the Committee on Homeland Security and Governmental Affairs, U.S. Senate 2 (May 20, 2008), available at *http://hsgac.senate.gov/public/__files/052008Masters.pdf* (last visited July 8, 2008) (quoting Michael W. Masters as stating "Are Institutional Investors contributing to food and energy price inflation? And my unequivocal answer is YES"); Oral Testimony of Edward Krapels, Hearing Before the Committee on Energy and Commerce Subcommittee on Oversight and Investigations, U.S. House of Representatives, (June 23, 2008) (quoting Mr. Edward Krapels as stating "I think the amount of speculation is really substantial [within the crude oil market.]"); Oral Testimony of Roger Diwan, Hearing Before the Committee on Energy and Commerce Subcommittee on Oversight and Investigations, U.S. House of Representatives, (June 23, 2008) (quoting Mr. Roger Diwan, responding to Rep. Whitfield's question: So you're saying if we adopt these regulatory changes, we could almost cut the retail price of gas in half in a relatively short period of time? "I don't know how quickly it takes to get prices down, but it's clear that prices will reflect closer the marginal cost of producing oil."); Alejandro Lazo, *Energy Stocks Haven't Caught Up With Oil Prices,* WASH. POST (Mar. 23, 2008), available at *http://www.washingtonpost.com/wp-dyn/content/article/2008/03/21/AR2008032103825.html* (last visited July 8, 2008) (quoting Mr. Fadel Gheit as stating "The largest speculators are the largest financial companies."); Michelle Foss, *United States Natural Gas Prices To 2015,* 34 (2007), available at *http://www.oxfordenergy.org/pdfs/NG18.pdf* (last visited July 8, 2008) (asserting "The role of speculation in oil markets has been widely debated but could add upwards of $20 to the price per barrel."); Tim Evans, *Citi Futures Perspective: PM Energy News & Views,* at 2 (July 3, 2008) (quoting "With the latest push to the upside, we see the crude oil market becoming even more completely divorced from any connection to fundamental factors and becoming even more obsessed with the simple question, How high can it go?"); Advantage Business Media, *Economist Blames Subsidies for Oil Price Hike,* CHEM. INFO (2008), available at *http://www.chem.info/ShowPR.aspx?PUBCODE=075&ACCT=0000100&ISSUE=0609&ORIGRELTYPE=DM&RELTYPE=PR&PRODCODE=00000&PRODLETT =M&CommonCount=0* (last visited July 8, 2008) (quoting Dr. Michelle Foss as stating "We have an overpriced commodity, and this is going to be around for a while."); Kenneth N. Gilpin, *OPEC Agrees to Increase Output in July to Ease Oil Prices,* N.Y. TIMES (June 3, 2004) available at *http://www.nytimes.com/2004/06/03/business/03CND-OIL.html?ex=1401681600&en=5dbd50c5b369795b&ei=5007&partner=USERLAND* (last visited July 8, 2008) (quoting Mr. Kyle Cooper as stating "There is not a crude shortage, which is why OPEC was so reluctant to raise production."); *Upstream, Speculators 'not to blame' for Oil Prices,* UPSTREAMONLINE.COM, (April 4, 2008), available at *http://www.upstreamonline.com/live/article151805.ece* (last visited July 8, 2008) (quoting Mr. Sean Cota as stating "It has become apparent that excessive speculation on energy trading facilities is the fuel that is driving this runaway train in crude prices"); Mike Norman, *The Danger of Speculation,* FOXNEWS.COM (Aug. 19, 2005), available at *http://www.foxnews.com/story/0,2933,166038,00.html* (last visited July 8, 2008) (Mr. Norman stating "Oil prices are high because of speculation, pure and simple. That's not an assertion, that's a fact. Yet rather than attack the speculation and rid ourselves of the problem, we flail away at the symptoms.").

[13] INTERNATIONAL MONETARY FUND, REGIONAL ECONOMIC OUTLOOK: MIDDLE EAST AND CENTRAL ASIA 27–28 (2008) ("Producers and many analysts say it is speculative activity that is pushing up oil prices now. Producers in particular argue that fundamentals would yield an oil price of about U.S. $80 a barrel, with the rest being the result of speculative activity."); see also Neil King Jr., *Saudi Arabia's Leverage In Oil Market Is Sapped,* WALL STREET J. (June 16, 2008), available at *http://online.wsj.com/article/SB121355902769475555.html?mod=googlenews__wsj* (last visited July 8, 2008) (quoting Saudi Oil Minister Ali Naimi as saying skyrocketing oil prices were "unjustified by the fundamentals" of supply and demand).

[14] *See* June 2007 Report, *supra* note 10, at 27.

[15] *See id.*

[16] *See* Written Testimony of Professor Michael Greenberger, *Energy Market Manipulation and Federal Enforcement Regimes: Hearing before the S. Comm. on Commerce, Science, and Transportation,* 3 (2008), available at *http://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1026&context=cong__test* (last visited July 8, 2008).

The Dubai Mercantile Exchange, in affiliation with NYMEX, a U.S. exchange, has also been granted permission to trade the U.S. delivered WTI contract on U.S. terminals, but is, by virtue of a CFTC No Action letter, to be regulated directly by the Dubai Financial Service Authority ("DFSA").[17] NYMEX describes itself as "a founder and has ownership share in [DME] and provides clearing services for that exchange."[18]

NYMEX itself, the U.S. premier regulated energy futures contract market capturing the overwhelming share, *e.g.,* of the U.S. delivered WTI futures market, has announced that it has applied to the United Kingdom's Financial Services Authority to have a NYMEX London trading platform registered with the that British agency,[19] after which NYMEX will apply for the kind of foreign board of trade no action relief that has already been granted to ICE and DME. Providing NYMEX's London trading platform with this kind of no action relief might very well convert full U.S. regulation of the most important U.S. crude oil futures contracts to considerable U.K. oversight.[20] These staff informal action letters, effectuating the exemptions for "foreign" owned U.S. trading terminals, by their own terms make it clear that they may be instantly revoked by the CFTC.[21]

One final gap in the oversight of excessive speculation in the U.S. crude oil (and agricultural) markets has been illuminated by the testimony of Michael W. Masters, Managing Member of Masters Capital Management, LLC, at recent May 20 and June 24 hearings before the Senate Committee on Homeland Security and Government Affairs.[22] Mr. Masters demonstrated that large financial institutions, such as investment banks and hedge funds, which were "hedging" their off exchange futures transactions on energy and agricultural prices on U.S. regulated exchanges, were being treated by NYMEX, for example, and the CFTC as "commercial interests," rather than as the speculators they clearly are.[23] By lumping large financial institutions with traditional commercial oil dealers (or farmers)[24] even fully regulated U.S. exchanges are not applying traditional speculation limits to the transactions engaged in by these speculative interests.[25] Mr. Masters has demonstrated that a significant percentage of the trades in WTI futures, for example, were controlled by noncommercial interests.[26] These exemptions from speculation limits for large financial institutions hedging off-exchange "swaps" transactions emanate from a CFTC letter issued on October 8, 1991[27] and they have continued to present day.[28]

Again, while the principal focus to date has been on skyrocketing energy prices, Mr. Masters' testimony, aided by a widely discussed cover story in the March 31, 2008 issue of *Barron's,*[29] has made clear that the categorization of swaps dealers outside of speculative controls even on U.S. regulated contract markets has been a cause of great volatility in food prices, as well as in the energy markets.

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[17] Dubai Mercantile Exchange Ltd., CFTC No-Action Letter, 2007 CFTC Ltr. LEXIS 6 (May 24, 2007).

[18] *See* Written Testimony of Jim Newsome, Hearing Before the Committee on Energy and Commerce Subcommittee on Oversight and Investigations, U.S. House of Representatives, at 6 (June 23, 2008) [hereinafter June 23, 2008 Testimony of Jim Newsome].

[19] *Id.*; Jeremy Grant, *Nymex's Long Road to the Electronic Age,* FINANCIAL TIMES (Feb. 17, 2006), at 39. ("Nymex has indicated that it might be forced to move its electronically traded WTI to London so that it can compete on a level playing field with ICE.").

[20] *See* June 23, 2008 Testimony of Jim Newsome, *supra* note 18.

[21] *See* Written Testimony of Professor Michael Greenberger, *Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?: Hearing Before the H. Subcomm. on Oversight and Investigations* 11–12 (2007) (providing a complete discussion of the No Action letter process including termination), available at *http://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1011&context=cong_test* (last visited July 8, 2008).

[22] Masters, *supra* note 12.

[23] *Id.* at 7–8.

[24] Gene Epstein, *Commodities: Who's Behind The Boom?,* BARRON'S 32 (March 31, 2008) ( "The speculators, now so bullish, are mainly the index funds. . . . By using the [swaps dealers] as a conduit, the index funds get an exemption from position limits that are normally imposed on any other speculator, including the $1 in every $10 of index-fund money that does not go through the swaps dealers.").

[25] Masters, *supra* note 12, at 7.

[26] *Id.* at 8, 11.

[27] J. Aron & Co., CFTC Interpretive Letter, 1991 CFTC Ltr. LEXIS 18 (Oct. 8, 1991).

[28] See Written Testimony of Michael Masters, Hearing Before Committee on Energy and Commerce Subcommittee on Oversight and Investigations, U.S. House of Representatives, at 5 (June 23, 2008) available at *http://energycommerce.house.gov/cmte_mtgs/110-oi-hrg.062308.Masters-testimony.pdf* (quoting "assets allocated to commodity index trading strategies have risen from $13 billion at the end of 2003 to $260 billion as of March 2008, and the prices of the 25 commodities that compose these indices have risen by an average of 183% in those 5 years!").

[29] *See* Epstein, *supra* note 24.

Many parties are now urging this Congress to close the Enron, London/Dubai, and Swaps Dealers Loopholes. On June 18, 2008, the Food Conservation and Energy Act of 2008[30] (the "Farm Bill") was enacted into law by a Congressional override of President Bush's veto. Title XIII of the farm bill is the CFTC Reauthorization Act of 2008, which, in turn, includes a provision that was intended to close the Enron Loophole.[31] This provision, while a good start, did not return to the *status quo* prior to the passage of the Enron Loophole: *i.e.,* it did not bring *all* energy futures contracts within the U.S. futures regulatory format. Rather, the farm bill amendment requires the CFTC "at its discretion" to prove on a contract-by-contract basis through administrative proceedings governed by the notice and comment provisions of the Administrative Procedure Act[32] that an *individual* energy contract should be regulated if the CFTC can prove that the contract "serve[s] a significant price discovery function" in order to detect and prevent excessive speculation and manipulation.[33] The farm bill Amendment affords the CFTC 15 months after enactment to implement that re-regulation process specified therein.[34]

The CFTC has publicly stated that it intends to apply the new legislation to only one of ICE's many[35] unregulated ICE energy futures contract, *i.e.,* only ICE's Henry Hub natural gas futures contract would be removed from the Enron Loophole protection and become fully regulated.[36] Thus, by this CFTC pronouncement, it now seems that no crude oil, gasoline, and heating oil futures contracts will be covered by the new legislation—not even the multi-billion agricultural/commodity index futures funds premised upon the prices of U.S. energy and agricultural commodities about which, *inter alia,* Michael Masters has testified are destabilizing the economic fundamentals of the agriculture and energy markets.

The CFTC has also made it clear that the farm bill amendment will not cover any *U.S.* futures contracts relating to the price of *U.S.* delivered commodities traded on the *U.S.* terminals of foreign exchanges operating pursuant to CFTC staff "no action" letters. As mentioned above, the Intercontinental Exchange ("ICE") of Atlanta, Georgia, for purposes of facilitating U.S. delivered WTI crude oil futures, is considered by the CFTC, through an informal staff No Action letter, to be a U.K. entity not subject to direct CFTC regulation even though ICE maintains U.S. headquarters and trading infrastructure, facilitating, *inter alia,* @ 30% of trades in U.S. WTI futures of its wholly owned the London subsidiary on which the no action permission is based. Moreover, the Dubai Mercantile Exchange ("DME"), in affiliation with NYMEX, a U.S. exchange, has also been granted permission to trade the U.S. delivered WTI contract on U.S. terminals, but is, by virtue of a CFTC No Action letter, directly regulated by the Dubai Financial Service Authority ("DFSA"). Again, even though the plain language of the farm bill does not exempt contract markets engaged in the U.S. trading of futures premised upon U.S. delivered commodities, the CFTC will not use the farm bill amendment to close the "London/Dubai" Loophole.

**Congress Should Insist Upon Full Market Transparency To Ensure That Excessive Speculation Is Not Overwhelming Crude Oil Futures Trading**

As the Committee knows, there is debate over whether the U.S. crude oil futures market is overrun by excessive speculation. As I have said, my own view is that those independent observers who understand those markets, by and large, concur that the markets have come unhinged from supply/demand fundamentals in a manner that makes them no longer useable by the physical hedgers who find prices to be "locked in" too volatile and distant from market fundamentals.[37]

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[30] Food Conservation and Energy Act of 2008, Pub. L. No. 110–246, § 13201; 122 Stat. 1651 (2008).

[31] *Id.*

[32] *See* RICHARD J. PRINCE, JR., ADMINISTRATIVE LAW TREATISE 424–25, 441–43 (4TH ED. 2002).

[33] Food Conservation and Energy Act of 2008, Pub. L. No. 110–246, § 13201; 122 Stat. 1651 (2008).

[34] *Id.* at § 13204.

[35] *See* Written Testimony of Jeffrey C. Sprecher, To Examine Trading Regulated Exchanges and Exempt Commercial Markets: Hearing of the Commodity Futures Trading Commission, (September 18, 2007), available at *http://files.shareholder.com/downloads/ICE/325023768x0x132117/53a6f61e-b72b-47ca-8f8e-f8282c21c12b/CFTC%20Testimony%20091807.pdf* (last visited July 8, 2008).

[36] *See* Written Testimony of Acting Chair Walter Lukken, *Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?: Hearing Before the H. Subcomm. on Oversight and Investigations,* 4 (Dec. 12, 2007) available at *http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opalukken-32.pdf* (emphasis added) (last visited July 8, 2008).

[37] See the many opinions from those experts in note 12 *supra*.

I would argue, however, that even if this Committee has doubts about whether excessive speculation or more serious malpractice are occurring in these markets and thereby unnecessarily driving up the price of crude oil, then those very doubts argue for legislation that makes these markets fully transparent. If all of these markets (*e.g.,* OTC, foreign board of trade U.S. trading terminals for futures dependent on U.S. commodities, and swaps dealers) were required to execute trades on U.S. designated contract markets or designated transaction execution facilities, the real time and constant reporting to both the CFTC and to the market's own self regulatory observers, would make it indisputably clear whether the markets are functioning solely on economic fundamentals; or whether excessive speculation is placing an unnecessary financial burden on them and the American energy consuming public.

As it is, those who reject transparency are those who ask the U.S. energy consumer to accept on blind faith (and I would argue in the face of substantial and reliable data pointing in the opposite direction) that these markets are functioning smoothly.

**A Prompt Return to the Time Tested Futures Regulatory Format Predating the Enron Loophole Will Create Much Needed Crude Oil Market Transparency**

Whatever form legislation takes to increase transparency in all U.S. traded energy futures, I would urge that the following principles be embedded therein to reassure the American energy consuming public that the price of crude oil is tied to market fundamentals rather than excessive speculation.

**Completely Close the Enron Loophole.** While the farm bill amendment was a good start, the radically rising price of crude oil even in the last few weeks now augurs for returning all U.S. energy futures trading to the safe harbor of fully transparent U.S. regulated contract markets. A simple amendment to existing law would redefine an "exempt commodity" as a commodity that does not include an agricultural or "*energy* commodity," thereby bringing all energy futures, including energy swaps based on the price of energy commodities, within the CEA's regulated contract market trading requirement. An energy commodity should include traditional energy products, *inter alia*, crude oil, gasoline, diesel fuel, heating oil, propane, electricity, and natural gas, as well as metals which have also seen a drastic run up in price. The result of this legislation would return U.S. energy futures trading to the same status as U.S. agricultural trading, which must be conducted on the U.S. registered contract market.

**U.S. Based Energy Futures Contracts Traded on U.S. Terminals Should Be Traded on U.S. Regulated Exchanges.** To address the concerns about the "London/Dubai" Loophole, any futures contract premised on the price of U.S. delivered energy futures and traded on U.S. trading terminals should be required to be traded on U. S. registered contract markets. This requirement would not affect the overwhelming number of foreign exchanges now trading within the U.S. who have continued to limit their trading to foreign futures contracts.

**Grace Periods.** Reasonable grace periods should be provided in this kind of legislation to accommodate conversion of energy futures trading not now under U.S. oversight. A grace period no longer than 6 months should accommodate this conversion.

**Aggregated Speculation Limits for Noncommercial Hedgers.** Consideration should also be given to requiring the CFTC to establish uniform speculation limits for noncommercial futures transactions involving the U.S. trading of energy futures contracts premised upon the price of U.S. delivered energy commodities. This would require the CFTC to "fix limits on the aggregate number of positions which may be held by any person" for each month and in *all* markets under CFTC jurisdiction. Under the existing regulatory regime, speculation limits are only applied by each contract market, and "aggregate positions" are never imposed. These aggregated limits would prevent a trader from spreading speculation over a host of markets, thereby accumulating a disproportionately large share of an energy market while satisfying each exchange's separate limits. The aggregated limits should not be applied to "*bona fide* hedging transactions" involving the trading of energy futures contracts by those having a true commercial interest in buying or selling the underlying commodity.

Legislation meeting most or all of the above listed criteria include H.R. 6341, introduced by Congressman Van Hollen and Congresswoman DeLauro, requiring all energy futures contracts executed in the U.S. to be traded on U.S. regulated contract markets, thereby building on the farm bill amendment's closure of the Enron Loophole by returning *all* energy futures trading, including the energy swaps market, to where it was immediately prior to that provision's passage, *i.e.,* on regulated

exchanges; and that legislation expressly requires the trading on U.S. terminals of futures contracts premised upon U.S. delivered energy commodities to be similarly subject to a U.S. regulated contract market. The latter provision would close the "London/Dubai" Loophole.

Congressman Stupak has introduced H.R. 6330, which mirrors in function the Van Hollen/DeLauro legislation, but, in what I refer to as a "belt and suspenders" approach, specifically brings energy swaps transactions into the regulated futures environment; nullifies after a grace period all foreign board of trade No Action letters; imposes CFTC imposed aggregated speculation limits on noncommercial interests for energy futures trading; requires speculation limits to be imposed on all traders except those who are hedging commercial interests related to the underlying commodity (thereby eliminating the hedge exemption from speculation limits for swaps dealers); and provides strict Congressional oversight of any exemptions provided to energy futures trading from the contract market requirements of the legislation.

Senator Nelson of Florida, with Senator Obama as a cosponsor, has introduced S. 3134, which is similar to that portion of H.R. 6341 requiring all energy futures contracts to be traded on regulated exchanges.[38] Senators Cantwell and Snowe have introduced S. 3122, which mirrors that portion of H.R. 6341 directed to closing the London/Dubai Loophole by requiring all trading of futures based on U.S. delivered energy commodity on U.S. platforms to be governed fully and directly by U.S. futures law.[39] S. 3205, introduced by Senator Cantwell, is the Senate version of Congressman Stupak's H.R. 6330.

Also worthy of consideration are Senators Lieberman and Collins legislative options designed to undercut excessive speculation in these markets through direct and aggregated controls on noncommercial futures traders. One of their proposals would require the CFTC to establish firm and aggregated speculation position limits on all U.S. speculative futures trading no matter where the platform on which the trading is geographically located.[40]

**There Are No Legal Restraints to Barring the "Foreign" Impact of Manipulation on U.S. Markets**

Arguments have been advanced that there are legal impediments to the CFTC applying U.S. regulatory protections on foreign boards of trade which bring their trading terminals to the U.S. If that argument were correct, it would be an impediment to much of the legislation cited above requiring the CFTC to do just that. These arguments are premised upon Section 4(b) of the Commodity Exchange Act (CEA). Section 4(b) provides in part:

> No rule or regulation may be adopted by the Commission under this subsection that (1) requires Commission approval of any contract, rule, regulation, or action of any foreign board of trade, exchange, or market, or clearinghouse for such board of trade, exchange, or market, or (2) governs in any way any rule or contract term or action of any foreign board of trade, exchange, or market, or clearinghouse for such board of trade, exchange, or market.[41]

However, this clause has been construed only to mean that the CFTC does not have jurisdiction over transactions conducted by *foreign* persons in a *foreign* country on a *foreign* board of trade.[42] *Kleinberg* v. *Bear Stearns,*[43] dealt with a situation where London traders were committing acts of fraud on a London exchange.[44] In that case, the Court held that the CFTC did not have enforcement jurisdiction, but explained, "It has been consistently held, at least implicitly, that CFTC may regulate and prosecute those who practice fraud in the United States in connection with commodities trading on foreign exchanges."[45]

To similar effect is the recent case of *Mak* v. *Wocom Commodities,*[46] concerning a Hong Kong resident placing futures trades with the defendant commodity brokers,

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[38] S. 3134, 110th Cong. (2008), available at *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:s3134is.txt.pdf* (last visited July 8, 2008).

[39] Policing United States Oil Commodities Markets Act of 2008, S. 3122, 110th Cong. (2008), available at *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:s3122is.txt.pdf* (last visited July 8, 2008).

[40] Discussion Draft to establish aggregate speculative position limits (2008), available at *http://hsgac.senate.gov/public/_files/aggspeclimits.pdf* (last visited July 8, 2008).

[41] 7 U.S.C. § 6(b) (2008).

[42] PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION 988 (2004 ed.).

[43] 1985 WL 1625 (1985).

[44] *Id.* at 1.

[45] *Id.* at 2 (internal citations omitted).

[46] 112 F.3d 287 (7th Cir. 1997).

both of which are Hong Kong corporations (Wocom).[47] The claims were denied because they were not sufficiently particularized.[48] However, the court stated that jurisdiction would have been extended if it had been clearly shown that there was "particularized harm to our domestic markets."[49] With ICE we currently have trading by U.S. customers in U.S. denominated currency on U.S. terminals in the foremost benchmark U.S. crude oil futures contracts with substantial evidence demonstrating "particularized harm to our domestic markets."

Indeed these cases are consistent with a fundamental tenet of Federal financial enforcement jurisprudence that Federal financial regulatory jurisdiction extends even to wholly foreign transactions when domestic financial markets suffer "from the effects of [an] improper foreign transaction[.]"[50] The leading commentators on U.S. derivatives regulation have, accordingly stated: "[E]ven without substantial activity in the United States, jurisdiction will exist when conduct abroad has a substantial affect upon U.S. markets and U.S. investors."[51]

Confirmation of this broad sweep of U.S. jurisdiction to address overseas malpractice significantly impacting U.S. markets is evidenced most clearly by the *Sumitomo* case.[52] In that case, the CFTC's enforcement division reached a settlement agreement with a Japanese corporation upon determining that the Japanese head copper trader of the Sumitomo Corporation manipulated the price of U.S. copper almost exclusively through trading done in London on the London Metals Exchange.[53] The CFTC imposed $150 million in fines and restitution.[54] Only a small portion of the trading was done in the U.S. and the London Metals Exchange contact with the U.S. was limited to a U.S. warehouse.[55] Despite these limited U.S. contacts, "the penalty [assessed was then] *the largest ever levied by a U.S. Government agency,*" and it was widely recognized that the settlement indicated that "manipulation of any commodity traded in the [U.S.] could be the subject of a C.F.T.C. action, *even if no acts were committed in this country.*"[56]

Clearly, then, trading done on trading platforms within the U.S. would be subject to full CFTC regulatory authority. The fact that ICE is headquartered in Atlanta with its trade matching engines in Chicago and it controls through its U.S. terminals over 30% of the lead U.S.-delivered petroleum contract only makes the jurisdictional question that much easier. The same is true of the Dubai exchange that partners with U.S.-based NYMEX to trade WTI contracts on U.S. terminals; and of the prospect of NYMEX opening a London trading platform for its energy futures products, but escaping U.S. regulation for that trading through a staff No Action letter treating NYMEX as if it were a U.K. entity.

Even more important, *Sumitomo* and its progeny are an answer to those many threats levied by large U.S. financial institutions that assert, if their trading on "foreign" trading terminals located in the U.S. is regulated, they will simply move that trading abroad. To be clear, any trading done in the U.S. on foreign exchanges is *a fortiori* covered by the applicable U.S. commodity laws.[57] So when the threat is made that the U.S. institutions will trade abroad, it means that it will be done completely outside of the sovereign U.S. However, the *Sumitomo* line of cases make clear that the CFTC, and for that matter, United States Department of Justice for purposes of related criminal prosecution,[58] can enforce violations of U.S. laws abroad if U.S. markets are significantly impacted by the wrongdoing in foreign countries. In short, speculators cannot escape the reach of U.S. civil and criminal law if they cause price distortions in U.S. commodity markets.

Moreover, as I have testified elsewhere, no exchange, wherever located, can develop liquidity in and maximize profits from trading U.S. delivered futures products

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[47] *Id.* at 288.
[48] *Id.* at 290–91.
[49] *Id.* at 291.
[50] *Des Brisay* v. *Goldfield Corp.,* 549 F.2d 133, 135 (9th Cir. 1977) (citing *Schoenbaum* v. *Firstbrook,* 405 F.2d 200, 206 (2d Cir. 1968), *modified in other respects,* 405 F.2d 215 (*in banc*), *cert. denied,* 395 U.S. 906, 89 S. Ct. 1747, 23 L. Ed. 2d 219 (1969)).
[51] JOHNSON & HAZEN, *supra* note 42, at 984.
[52] In the Matter of Sumitomo Corporation, 1998 CFTC LEXIS 96 (1998).
[53] *Id.* at 2–3.
[54] *Id.* at 24–25.
[55] *Id.* at 11–14.
[56] Floyd Norris, *The Markets; A Record Penalty of Sumitomo, a Lesson on Market Volatility,* N.Y. TIMES (May 12, 1998), at D13 (emphasis added).
[57] JOHNSON & HAZEN, *supra* note 42, at 984.
[58] See Press Release, Department of Justice, U.S. Charges 47 After Long-Term Undercover Investigation Involving Foreign Exchange Markets, (Nov. 19, 2003), available at *http://www.fbi.gov/dojpressrel/pressrel03/wooden111903.htm* (last visited July 8, 2008).

without having a substantial U.S. presence.[59] This is evidenced by the 18 CFTC staff No Action letters issued to foreign exchanges from all over the world allowing the placement of trading terminals in the U.S.[60] In short, the threat that trading in U.S. delivered commodities will be done exclusively abroad is idle when confronted by both economic and legal realities.

**The IntercontinentalExchange Cannot Fairly Be Deemed British for Purposes of Trading U.S. Petroleum Futures in U.S. Dollars on U.S. Trading Terminals with U.S. Trading Engines**

Of course, all of the above jurisdictional analysis assumes that ICE (and DME) are "foreign" boards of trade. While ICE has a London wholly owned subsidiary, that office is controlled by ICE's headquarters in Atlanta; ICE's trading engines are in Chicago; it is trading over 30% of the U.S. premier crude oil futures contract in U.S. denominated currency. ICE's non-petroleum products, *i.e.,* natural gas futures contracts, are clearly traded within U.S. jurisdiction and are subject to re-regulation under U.S. law by virtue of the farm bill's "End the Enron Loophole" provision.[61] ICE also owns a fully regulated U.S. exchange: formerly the New York Board of Trade (NYBOT); now ICE Futures U.S. It defies all logic that such an exchange can be called "foreign" based on the name given to its wholly owned subsidiary (ICE Futures Europe) and maintaining a London office that could as easily be operated out within the U.S.

The same is also true of the Dubai Mercantile Exchange. Its principal partner is the New York Mercantile Exchange (NYMEX), a U.S. regulated exchange and a U.S. entity. The President of NYMEX sits on DME's board. DME has authority to trade the U.S. delivered WTI contract on trading terminals in the U.S. Under these circumstances, DME is clearly a U.S. exchange.

The illogic of the FBOT staff no action process is highlighted by NYMEX, a U.S. regulated exchange headquartered in the U.S., establishing a London futures trading platform under the United Kingdom's regulatory regime and then applying for an FBOT staff No Action letter to allow trading within the U.S. on its NYMEX London platform. NYMEX will then have converted itself from a U.S. entity into a British entity for purposes of U.S. trades on the platform with the principal regulation of those trades in the hands of the United Kingdom.

And, why should NYMEX not do this? It is following precisely the ICE template. However, the proposal defies all good sense, and, even worse, it will add darkness to the trading markets that affect the price of crude oil, gasoline, and heating oil within the U.S.

Under the ICE, DME and London/NYMEX scenarios, each of these exchanges are clearly U.S. exchanges and their trading terminals should be regulated as U.S. regulated contract markets. Moreover, as U.S. contract markets, they and the traders on those exchanges (no matter whether they trade in the U.S. or abroad) are fully subject to both CFTC civil jurisdiction and United States Federal criminal statutes.[62] For example, in *Tamari* v. *Bache*[63] the Seventh Circuit held there was Federal jurisdiction to enforce the Commodity Exchange Act, even though the trader and the trader's broker accused of fraud were both situated in Lebanon,[64] by stating: "that Congress intended to proscribe fraudulent conduct associated with any commodity future transactions executed on a domestic exchange, regardless of the location of the agents that facilitate the trading" and thus there was jurisdiction.[65]

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[59] Written Testimony of Professor Michael Greenberger, *Energy Market Manipulation and Federal Enforcement Regimes: Hearing Before the United States Senate Committee on Commerce, Science, and Transportation,* 12 (2008), available at *http://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1026&context=cong__test* (last visited July 8, 2008).

[60] U.S. Commodity Futures Trading Commission, Foreign Boards of Trade Receiving Staff No Action Letters Permitting Direct Access from the U.S., available at *http://services.cftc.gov/sirt/sirt.aspx?Topic=ForeignTerminalRelief* (last visited July 8, 2008).

[61] Food Conservation and Energy Act of 2008, Pub. L. No. 110–246, § 13201; 122 Stat. 1651 (2008); Jessica Marron, *House and Senate Lawmakers Move to Close 'Enron Loophole' with Amendment to Farm Bill,* PLATTS GLOBAL POWER REPORT, (May 1, 2008) (stating that the "initial target of the [the Farm's Bill End the Enron Loophole Provision] is ICE's financially settled Henry Hub swap contract").

[62] JOHNSON & HAZEN, *supra* note 42, at 986 (citing In the Matter of Ralli Brothers Bankers, [1986–1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23, 314 (1986)).

[63] 730 F.2d 1103 (7th Cir. 1984).

[64] *Id.* at 1104–05.

[65] *Id.* at 1108; JOHNSON & HAZEN, *supra* note 42, at 987.

**The CFTC Has Consistently Viewed Foreign Exchanges Trading on U.S. Terminals Subject to Full U.S. Regulation**

It has been shown immediately above, that as a legal matter there is no bar either within the CEA as now drafted nor within the case law that prevents the CFTC from gaining full regulatory control, over any futures trading done in the U.S. Even if one were to assume that ICE, for example, is truly a foreign board of trade, Section 4(b) only bars regulation of trading done by foreign citizens in foreign countries trading foreign commodities on foreign exchanges when such trading does not cause substantial dysfunctions to U.S. markets. Below it is shown that this well established law has governed the CFTC's FBOT staff no action process since its inception.

The staff no action process initiated in 1999 was not developed under a view that, pursuant to Section 4(b), the CFTC could not regulate foreign exchanges who wished to put trading terminals in the U.S. To the contrary, the history is clear that those foreign exchanges themselves recognized that, in the absence of an exemption under Section 4(c) of the CEA,[66] they would have to fully register as a U.S. contract market. As their plain language made clear when they were first issued in 1999, the FBOT No Action letters originated from a rulemaking proceeding that, by its very terms, indicated that permission to put terminals in the U.S. derived from Section 4(c)'s exemption from full regulation and not from Section 4(b)'s absolute bar against foreign regulation.[67] It must be remembered that Section 4(b) does not countenance exceptions to its general restriction. The No Action letters include a myriad of regulatory conditions on the foreign boards of trade that are completely inconsistent with the absolute bar within Section 4(b).[68]

If there were any doubt about the above analysis, it was belied by the actions of the CFTC on June 17, 2008 and July 8, 2008, when it added four new conditions to the existing ICE Futures Europe and Dubai Mercantile Exchange No Action letters.[69] While these additional conditions have only been applied to ICE and DME, Acting Chairman Lukken's related comments show that the CFTC has the authority to incorporate them in the now outstanding 14 other FBOT staff No Action letters affecting every foreign board of trade with U.S. terminals, as well as any FBOT that seeks an exemption from U.S. direct regulation in the future.[70]

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[66] Written Testimony of Professor Michael Greenberger, *Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?: Hearing Before the H. Subcomm. On Oversight and Investigations,* 14–15 (2007), available at *http://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1011&context=cong_test* (last visited July 8, 2008).

[67] *See, e.g.,* LIFFE Administration & Management, CFTC No-Action Letter, 1999 CFTC Ltr. LEXIS 38, 4–5 (July 23, 1999); Access to Automated Boards of Trade (proposed rules), 64 *Fed. Reg.* 14,159, 14,174 (Mar. 24, 1999).

As the proposed rules explained,

> Section 4(c) of the Act provides the Commission with authority "by rule, regulation, or order" to exempt "any agreement, contract or transaction" from the requirements of Section 4(a) of the Act if the Commission determines that the exemption would be consistent with the public interest, that the contracts would be entered into solely by appropriate persons and that the exemption would not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act. *Id.* (internal citations omitted).

[68] Among the conditions present in all of the No Action letters are the following: the exchange will satisfy the appropriate designation in its home jurisdiction, the exchange must work to ensure fair markets that prohibit fraud and other abuses by providing adequate supervision, continued adherence to IOSCO Principles for Oversight of Screen-Based Trading Systems for Derivative Products, members and guaranteed customers will only receive direct access if a clearing member guarantees and assumes all financial liability, there are sufficient safeguards to prevent unauthorized access or trading, at the Commission's request recipients will provide market information including access to books and records, and will submit all contracts to be made available through the no-action process, the volume of said trades and a list of names and addresses of all those using these exchanges. *See*, e.g., LIFFE Administration and Management, CFTC No-Action Letter, 1999 CFTC Ltr. LEXIS 38, 65–72 (July 23, 1999); IPE, CFTC No-Action Letter, 1999 CFTC Ltr. LEXIS 152, 58–66 (Nov. 12, 1999); Dubai Mercantile Exchange Ltd., CFTC No-Action Letter, 2007 CFTC Ltr. LEXIS 6, 87–96 (May 24, 2007).

[69] Amendment to No-Action Letter Issued to the International Petroleum Exchange of London (now ICE Futures Europe), CFTC No-Action Letter, (June 17, 2008), available at *http://www.cftc.gov/stellent/groups/public/@lrlettergeneral/documents/letter/08-09.pdf* (last visited July 8, 2008); Press Release, CFTC, CFTC Conditions Foreign Access on Adoption of Position Limits on London Crude Oil Contract (June 17, 2008) available at *http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5511-08.html* (last visited July 8, 2008).

[70] Press Release, CFTC, CFTC Conditions Foreign Access on Adoption of Position Limits on London Crude Oil Contract (June 17, 2008) available at *http://www.cftc.gov/newsroom/*

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If Section 4(b)'s absolute prohibition were applicable to FBOTs with U.S. terminals, as some have argued as a predicate to limiting legislative or administrative action in this area, how could the CFTC add these new conditions to the outstanding No Action letters? Those new conditions, *inter alia,* require large trader reporting and the imposition of speculation limits.[71] The failure of the FBOTs to comply could result in the revocation of the No Action letters, thereby requiring each FBOT to register as a fully regulated U.S. contract market.[72]

Those who would attempt to limit Congressional and regulatory controls on ICE, DME, and NYMEX/London have also relied upon a November 2006 policy statement issued by the CFTC on the FBOT No Action letter process.[73] Much is made about the fact that Section 4(b) is cited and quoted therein. Whatever the purpose of that 4(b) reference, the assertion that 4(b) presents an absolute bar is belied by the following within that policy statement:

> [i]n the absence of no-action relief, a board of trade, exchange or market that permits direct access by U.S. persons might be subject to Commission action for violation of, among other provisions, section 4(a) of the CEA, if it were not found to qualify for the exclusion from the DCM designation or DTEF registration requirement.[74]

In short, the failure to gain no action relief would mean that, in the absence of registration as a fully regulated contract market, the FBOT would have to remove its U.S. terminals according to the CFTC's own analysis. As the CFTC expressly stated in its June17, 2008 letter to ICE imposing the new conditions on its no action status, if ICE satisfies the four new conditions, the CFTC "will not recommend that the Commission institute enforcement action against [ICE] based upon [ICE's] failure to seek contract market designation or registration as a DTEF under Sections 5 and 5a of the Act."

Again, the action of the CFTC adding further conditions to the ICE No Action letter, including large trader reporting and speculation limits, upon pain of an enforcement proceeding based on the failure to register as a U.S. regulated contract market, clearly demonstrates that the CFTC meant what it said in the above quoted reference from its 2006 policy statement, it has broad powers to require a "foreign" exchange to fully register in the U.S. or terminate its presence in this country.[75] Section 4(b) provides no impediment to those powers.

**Efforts Designed To Oversee and Improve the Foreign Regulation of U.S. Delivered Futures on U.S. Terminals May Not Effectively Close the "London/Dubai" Loophole**

Congressman Etheridge of this Committee[76] and Senators Durbin and Levin in the Senate have introduced legislation which ratchets up the existing CFTC oversight of foreign boards of trade energy futures trading on U.S. trading terminals ("FBOTs"). That legislation, while a major improvement over the present regulatory environment, still leaves primary and direct enforcement and oversight in the hands of the foreign regulator, *e.g.,* the U.K.'s Financial Services Authority in the case of ICE; or the Dubai Financial Services Authority in the case of the DME.

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*generalpressreleases/2008/pr5511-08.html* (last visited July 8, 2008). As Acting Chairman Lukken stated,

> These new conditions for foreign access will provide the CFTC with additional oversight tools to monitor linked contracts. This powerful combination of enhanced trading data and ad ditional market controls will help the CFTC in its surveillance of regulated domestic exchanges, while preserving the important benefits of our international recognition program that has enabled proper global oversight during the last decade. This raises the bar for all future foreign access requests and will ensure uniform oversight of linked contracts. *Id.*

[71] Amendment to No-Action Letter Issued to the International Petroleum Exchange of London (now ICE Futures Europe), CFTC No-Action Letter, (June 17, 2008) available at *http://www.cftc.gov/stellent/groups/public/@lrlettergeneral/documents/letter/08-09.pdf* (last visited July 8, 2008).

[72] *See supra* notes 68–70 and accompanying text.

[73] Boards of Trade Located Outside of the United States and No-Action Relief from the Requirement to Become a Designated Contract Market or Derivatives Transaction Execution Facility, 71 *Fed. Reg.* 64443 (Nov. 2, 2006).

[74] *Id.* at 64,445 n. 23.

[75] Amendment to No-Action Letter Issued to the International Petroleum Exchange of London (now ICE Futures Europe), CFTC No-Action Letter, (June 17, 2008) available at *http://www.cftc.gov/stellent/groups/public/@lrlettergeneral/documents/letter/08-09.pdf* (last visited July 8, 2008).

[76] H.R. 6334.

It is my understanding the this legislation deferring to the primacy of foreign regulators to oversee U.S. terminals operated by FBOTs derives from a concern that section 4(b) of the Act bars U.S. regulation of even those FBOTs in the U.S.[77] As has been shown above,[78] section 4(b), whatever it means, is an absolute bar to any U.S. regulation,[79] whereas H. 6334 does ratchet up U.S. regulation of the foreign exchange. Moreover, as shown above,[80] section 4(b)'s bar only applies to foreign trades on foreign exchanges of foreign commodities not having a significant impact on U.S. markets. Therefore, policy concerns about section 4(b) should not govern the regulation of FBOT terminals in the U.S., especially when those terminals trade U.S. delivered futures contracts; and even more so when the FBOTs institutional ties are so closely affiliated with the U.S. and U.S. institutions that the FBOT loses all claim to foreign status.

Again, legislation such as that proposed by Congressman Etheridge, is a major improvement of what had been the CFTC's oversight of FBOTs' U.S. terminals.

This kind of legislation affords the CFTC the authority to enforce the prohibitions of section 9 of the Act, concerning criminal penalties, including anti-manipulation prohibitions therein, and "to limit, reduce, or liquidate any position" on the FBOT in aid of preventing, *inter alia,* manipulation and excessive speculation enforcement.[81] Imposition of restrictions on the FBOT, however, must be preceded by consultation with the FBOTs foreign regulator.[82]

The CFTC "may apply such record-keeping requirements [to the FBOT] as the Commission determines are necessary,"[83] and before the CFTC exempts an FBOT from full U.S. contract market regulatory requirements, it must ensure that the FBOT operating the U.S. terminals "appl[y] comparable principles" to those of the CFTC for "daily publication of trading information and position limits or accountability levels for speculators" and provides to the CFTC "the information that the [CFTC] determines necessary to publish a Commitment of Traders report" for U.S. regulated contract markets.[84]

Legislation of the kind introduced by Congressman Etheridge also requires the CFTC to conduct a review of FBOT no action status for existing FBOTs between the first anniversary of the passage of S. 3130 and 1½ years thereafter to ensure FBOT compliance with the new statutory requirements imposed by this legislation.[85]

In any event, recent actions taken by the CFTC to increase regulation of ICE and DME may place the requirements of Congressman Etheridge's bill in a new context.

**CFTC's New Regulatory Requirements for Foreign Boards of Trade With U.S. Terminals**

For at least 2 years prior to May 20, 2008, the CFTC had repeatedly assured Congress and market participants that the dramatic rise in crude oil, natural gas, gasoline, and heating oil was caused exclusively by supply/demand market fundamen-

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[77] *See supra* notes 41–42 and accompanying text.
[78] *See supra* notes 43–60 and accompanying text.
[79] *See supra* notes 43–60 and accompanying text.
[80] *See supra* note 42 and accompanying text.
[81] See S. 3130 § 7, 110th Cong. (2008), available at *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:s3130is.txt.pdf* (last visited July 8, 2008).
[82] *See id.*
[83] *Id.*
[84] *Id.* at § 6.
[85] *Id.* at § 11.

tals.[86] The CFTC had based its conclusions on its "exhaustive" research of all relevant market data.[87]

Indeed, as recently as May 20, 2008, before the full Senate Homeland Security and Government Affairs Committee, the CFTC's Mr. Harris, testified: "[A]ll 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 [agriculture and energy] markets. . . . [O]ur *comprehensive* analysis of the *actual* position data of these traders fails to support [the] contention" that there is excessive speculation or manipulation.[88] Rather, he said "prices are being driven by powerful economic fundamental forces and the laws of supply demand."[89]

In a rather dramatic about face, the CFTC suddenly announced on May 29, 2008 (or just 9 days after Mr. Harris testimony) that that agency is in the midst of an investigation into the crude oil energy markets[90] and it will now begin to collect substantial amounts of new data to determine what is undergirding high oil prices.[91] This reversal in course is almost certainly the product of intense pressure placed on the CFTC by Congress to ensure that excessive speculative activity is not being conducted on the principal market over which the CFTC has declined primary responsibility, *i.e.,* trading done on ICE and on ICE's U.S. terminals.[92]

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[86] Walt Lukken, Acting Chairman, CFTC, Prepared Remarks: Compliance and Enforcement in Energy Markets—The CFTC Perspective (Jan. 18, 2008), available at *http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opalukken-34.pdf* (last visited June 21, 2008) (quoting Mr. Walter Lukken "While speculators play a integral role in the futures markets, the report concludes that speculative buying, as a whole, does not appear to drive up price"); Tina Seeley, *Energy Market Not Manipulated, U.S. Regulator Says (Update1),* BLOOMBERG.COM (May 7, 2008), available at *http://www.bloomberg.com/apps/news?pid=20601072&sid=aX0iaEd9bOMU&refer=energy* (last visited June 21, 2008) (quoting Mr. Walter Lukken, "We have not seen that speculators are a major factor in driving these prices"); Ian Talley & Stephen Power, *Regulator Faults Energy-Futures Proposal,* WALL ST. J. (May 8, 2008) (stating that Mr. Walter Lukken commented that his agency hadn't seen evidence indicating that speculators are "a major factor" in driving up oil prices); Oral Testimony of Walter L. Lukken, Commissioner, CFTC, *Before the Committee on Agriculture, U.S. House of Representatives,* (April 27, 2006) (quoting Mr. Walter Lukken "[B]ased on our surveillance efforts to date, we believe that crude oil and gasoline futures markets have been accurately reflecting the underlying fundamentals of these markets"); Sharon Brown-Hruska, Chairman, CFTC, Address before the International Monetary Fund: Futures Markets in the Energy Sector (Jun. 15, 2006), available at *http://www.cftc.gov/newsroom/speechestestimony/opabrownhruska-46.html* (last visited Jun. 21, 2008) (stating "To date, the staff' findings have shown that these large speculators as a group tend to inject liquidity into the markets rather than having an undue impact on price movements"); Sharon Brown-Hruska, Chairman, CFTC, Keynote Address at the Managed Funds Association Annual Forum (Jun. 25, 2005), available at *http://www.cftc.gov/opa/speeches05/opabrownhruska34.htm* (last visited June 21, 2008) (stating the CFTC's study of the role of managed funds in our markets, "[C]ontradicts with force the anecdotal observations and conventional wisdom regarding hedge funds and speculators, in general.").

[87] *See, e.g., supra* note 86 and accompanying text.

[88] Written Testimony of Jeffrey Harris, Chief Economist, CFTC, *Before the Senate Committee on Homeland Security and Governmental Affairs,* United States Senate 20 (2008), available at *http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/oeajeffharristestimony052008.pdf* (last visited June 21, 2008).

[89] *Id.; see, e.g.,* Richard Hill, *Lieberman Says He Will Consider Legislation to Address Commodity Prices,* 40 BUREAU OF NAT'L. AFF. 21 (May 26, 2008) (emphasis added), available at *http://corplawcenter.bna.com/pic2/clb.nsf/id/BNAP-7EVTDG?OpenDocument* (last visited June 21, 2008).

[90] CFTC Commissioner Bart Chilton has acknowledged that the public announcement within the May 29 release raises the specter that "some people [will] head for the paper shredder [.]" Tina Seeley, *CFTC Targets Shipping, Storage in Oil Investigation (Update2),* BLOOMBERG.COM (May 30, 2008), available at *http://www.bloomberg.com/apps/news?pid=20601087&sid=aGzRMmD__b9MA&refer=home* (last visited June 21, 2008).

[91] Press Release, U.S. Commodity Futures Trading Commission, CFTC Announces Multiple Energy Market Initiatives (May 29, 2008), available at *http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5503-08.html* (last visited June 21, 2008).

[92] See Letter from Twenty-Two Senators to Walter Lukken, Acting Chairman, CFTC (May 23, 2008), available at *http://cantwell.senate.gov/news/record.cfm?id=298325* (last visited June 21, 2008) (insisting that CFTC require ICE to demonstrate why it should not be subject to the same regulation as other U.S.-based exchanges and warning, "[a]bsent expeditious Commission action, Congress may need to step in to protect consumers and ensure that all markets trading U.S. delivered energy futures are transparent and free of fraud, manipulation, and excessive speculation"); Letter from Senator Jeff Bingaman to Walter Lukken, Acting Chairman, CFTC (May 27, 2008), available at *http://energy.senate.gov/public/index.cfm?FuseAction=PressReleases.Detail&PressRelease__id=0fdd0eb4-4b1d-49f0-a3a2-f89fd0e4b1d3&Month=5&Year=2008&Party=0* (last visited June 21, 2008) (expressing concern that that "the Commission's assertions to date—discounting the potential role of speculation in driving up oil prices—have been based on a glaringly incomplete data set" and demanding an explanation of many CFTC activities); *Energy Speculation: Is Greater Regulation Necessary to*

As crude oil and gas prices continued to spike even after the CFTC's May 29, 2008, announcement, the pressure on the CFTC did not let up. Thus, by June 17, 2008, the CFTC once again increased its pressure on ICE.

In a dramatic June 17, 2008 letter to ICE, the CFTC Director of Market Oversight referenced the fact that ICE had moved its trading platform from London "to the ICE Platform operated by [ICE] in Atlanta, Georgia," and that that U.S. platform was now trading three U.S. delivered energy futures products (WTI, heating oil, and gasoline) "each of which is cash-settled on the price of physically-settled contracts traded on NYMEX."[93] Most importantly, the June 17 letter to ICE then stated:

> A foreign board of trade listing for trading a contract which settles on the price of a contract traded on a CFTC-regulated exchange *raises very serious concerns* for the Commission. . . . In the absence of preventive measures at [ICE], this circumstance *could compromise the [CFTC's] ability to carry out its market surveillance responsibilities,* as well as the integrity of prices established on CFTC-regulated exchanges . . . [T]he division retains the authority to condition further, modify, suspend, terminate, or otherwise restrict the terms of the no-action relief provided herein, in its discretion.[94]

In order to address the CFTC's "very serious concerns" that it had "compromise[d] [its own] ability to carry out its market surveillance responsibilities, as well as the integrity of the prices established" thereon, the letter then outlined four new conditions that it imposed upon ICE: "position limits or position accountability levels (including related hedge exemption provisions) as adopted by" U.S. regulated contract markets; quarterly reports of any member exceeding those levels and limits; publication of daily trading information comparable to that required of U.S. contract markets; daily reporting of "large trader positions" as provided by U.S. regulated markets.[95]

ICE was given 120 days to come into compliance with the new CFTC conditions.[96] The CFTC acknowledged that the new ICE rules would have to be approved by the FSA.[97] The June 17 letter to ICE concludes by stating that only if ICE complies with the conditions outlined therein can ICE be assured that the CFTC will "not recommend that the Commission institute enforcement action against [ICE] or its members" based on ICE's failure to register as a U.S. regulated contract market.[98]

On June 17, 2008, the day that that letter to ICE was released, CFTC Acting Chairman Lukken is reported to have told the Senate oversight Committee: "The CFTC will also require other foreign exchanges that seek such direct access to provide the CFTC with comparable large trader reports and to impose comparable position and accountability limits for any products linked with U.S. regulated futures contracts[.]"[99] On July 7, 2008, an identical CFTC staff letter was written to the DME.

It would seem that much of what the CFTC has done implements the data collection requirements included in Congressman Etheridge's bill. Indeed, the CFTC's threat of enforcement authority against ICE in its June 17, 2008 letter, while limited for these purposes to failing to register as a U.S. regulated contract market, would seem to make it clear that that agency could enforce all civil and criminal penalties asserted throughout the CEA against ICE and its members if appropriate, thereby possibly even exceeding the grant of section 9 enforcement powers afforded the CFTC with regard to FBOTs in S. 3130.

As will be shown below, however, the present skyrocketing cost of crude oil and its derivative products, as well as the resulting destabilization of the U.S. economy, would seem to counsel the use of the full force of the CFTC's powers to bring ICE and similar "foreign" exchanges with trading terminals in the U.S. trading futures

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*Stop Price Manipulation?: Hearing Before the House Subcomm. on Oversight & Investigations,* 110th Cong. (2007) (statement of Rep. Joe Barton, Member, House Subcomm. on Investigations) (informing Walter Lukken, Acting Chairman, CFTC, that Congress had empowered FERC to provide additional regulation in some energy markets because they were displeased with the CFTC's efforts).

[93] Amendment to No-Action Letter Issued to the International Petroleum Exchange of London (now ICE Futures Europe), CFTC No-Action Letter 2 (June 17, 2008), available at *http://www.cftc.gov/stellent/groups/public/@lrlettergeneral/documents/letter/08-09.pdf* (last visited June 20, 2008).

[94] *Id.*

[95] *Id.* at 3.

[96] *Id.*

[97] *Id.*

[98] *Id.*

[99] Nick Snow, *US CFTC Unveils New Foreign Market Data Pact,* OIL & GAS J., (June 18, 2008), available at *http://www.mapsearch.com/news/display.html?id=332086* (last visited June 21, 2008).

premised on U.S. delivered energy commodities under complete, direct, and real time U.S. regulatory control.

**Deference to Foreign Regulators over U.S. Energy Futures Trading Deprives U.S. Energy Markets and U.S. Energy Consumers of the Full Weight of CEA Protections**

The question arises whether the U.S. should continue to regulate FBOT trading of U.S. energy futures on U.S. terminals principally through foreign regulators while requiring more aggressive CFTC oversight of that process. Or, should trading of U.S. delivered energy products on U.S. terminals be deemed a sufficient nexus to the U.S. and the well being of its economy to require direct U.S. supervision. If Congress settles for the *status quo* as evidenced by the CFTC's most recent actions if forsakes a wealth of traditional regulatory tools that the CFTC has to ensure that U.S. energy markets and prices are rooted in economic fundamentals.

**The Lack of Emergency Authority to Intervene in Market Distortions.** The most substantial risk in following the CFTC policy of leaving ICE and other similarly situated "foreign" exchanges under the principal supervision of foreign regulators while those exchanges have U.S. terminals trading critically important U.S. delivered energy products is that the CFTC cannot exercise its broad emergency authority to intervene immediately when confronted with emergencies and dysfunctions on U.S. regulated contract markets.[100]

Described as the CEA's "most potent tool," section 8a(9) provides that "whenever [the CFTC] has *reason to believe* that an emergency exists," it may take such actions "including, but not limited to 'the setting of temporary emergency margin levels on any futures contract [and] the fixing of limits that may apply to a market position."[101] An "emergency" is defined:

> "to mean, in addition to threatened or actual market manipulations and corners, any act of the United states or a foreign government affecting a commodity or any other major market disturbance *which prevents the market from accurately reflecting the forces of supply demand for such commodity*."[102]

It should be born in mind that these emergency powers afford the CFTC the immediate right to alter on a real time basis margin requirements and speculation and position limits to deal with crises as they arise "*which prevent[] the market from accurately reflecting the forces of supply demand[.]*" While section 8a(9) affords direct judicial review of orders after they are issued in a Federal court of appeals, it does not by its terms require emergency orders to be preceded by notice and an opportunity to be heard, thereby ensuring speedy restoration of normal market processes.[103]

When one reads this broad power afforded to the CFTC, one could reasonably ask why it has not been used on days such as Friday, June 6, 2008 when the WTI crude oil futures prices rose nearly $11 per barrel in a single day.[104] That is best explained by the fact that the only real time market data in the hands of the CFTC on that day was from NYMEX—the fully regulated U.S. exchange with speculation limits in place; perhaps if the CFTC had meaningful and real time ICE data on that day, thereby seeing the entirety of the WTI crude oil market, it might have seen a need to intervene under its emergency authority to impose temporary position limits and margin requirements to cool down what was widely viewed as breathtaking volatility.

Of course, even when it receives the ICE data within 120 days of its June 17, 2008 requirements, the CFTC will still not have the authority under the governing CFTC No Action letter to use its emergency intervention powers on ICE even though over 60% of ICE U.S. delivered WTI futures trading is done within our own country. Rather than exercising real time emergency authority, the CFTC will have to once again "negotiate" with the FSA to have that U.K. regulator intervene to deal with, *inter alia,* ICE WTI trade matching systems located in Chicago, Illinois.

Moreover, relying upon the FSA to intervene on a real time basis for a "major market disturbance" on a U.S. delivered energy futures contract traded on U.S. terminals is as problematic as a matter of policy as it is as a matter of logistics. Unlike the robust emergency authority given by Congress to the CFTC under section 8a(9),

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[100] JOHNSON & HAZEN, *supra* note 42, at 1218.
[101] 7 U.S.C. § 2a(9) (2008) (emphasis added).
[102] *Id.* (emphasis added).
[103] JOHNSON & HAZEN, *supra* note 42, at 1221–22.
[104] SEE SIMON WEBB, *OPEC hike unlikely at emergency oil talks,* REUTERSUK, (June 20, 2008), available at *http://uk.reuters.com/article/oilRpt/idUKL2058919720080620* (last visited July 8, 2008).

the FSA emergency powers have been implemented in a quite lackluster fashion. While its governing statute affords intervention power,[105] FSA makes clear on its website that the U.K. has translated any such authority when "major operational disruptions" are detected on ICE, to a "Tripartite Standing Committee" that would convene the "Cross Market Business Continuity Group" (CMBCG) to:

> "provide[] a forum for establishing senior-level practitioner views . . . Its role is advisory: decisions will be for the relevant official or market authorities or for firms themselves either individually or collectively through the agency of the CMBCG. The CMBCG may also have a role in pooling information to help facilitate private sector decisions and workarounds to alleviate pressures on the system." [106]

This U.K. guidance for sharing "views" and for "pooling information" in an "advisory" capacity to "help facilitate private sector" decisions in London is what the U.S. industrial consumers of crude oil and the U.S. gas consuming public are left to fall back upon when WTI crude oil soon skyrockets to $150 per barrel as has been predicted by Morgan Stanley, one of the founders of ICE.[107] The CFTC's June 17 imposition of new conditions on ICE do not convert the U.K.'s lackluster emergency responses into the vigorous emergency responses called for by U.S. law.

Indeed, any effort by Congress to insist upon "comparability" on emergency powers is futile. As the *Financial Times* has so aptly commented on June 20, 2008, the U.K.'s futures regulator "operates a . . . system of 'credible deterrence' of wrongdoing by *engaging in a dialogue with market participants.* Since the FSA's creation in 1997, it has brought *no* civil or criminal cases in energy markets." [108] In stark contrast, as Acting Chairman Lukken recently proudly reported to Congress: "[s]ince December 2002 to the present time, the [CFTC] has filed a total of 39 enforcement actions charging a total of 64 defendants with violations involving the energy markets," having referred "35 criminal actions concerning energy market misconduct" to the Department of Justice.[109]

The contrast between FSA and CFTC enforcement activity in the energy futures markets under their control is quite remarkable, especially since ICE is responsible for nearly 50% of all crude oil futures contracts traded worldwide and since the CFTC has not had access to meaningful ICE data.[110]

The American gas consuming public's trust in the FSA might also be shaken by the U.K.'s response to the June 17, 2008 CFTC announcement of the imposition of new transparency requirements on ICE's use of U.S. terminals used as a critical part of ICE's control of over 30 % of the U.S. delivered WTI contract. Mr. Stuart Fraser, head of policy at the City of London Corporation, is reported in the *Financial Times* to have called the CFTC June 17 letter "American imperialism," and adding for measure "if a bunch of [S]enators want to get rude about the FSA, that's fine, but don't interfere in *our* market." [111]

Of course, the UK is wrong to think trading on U.S. terminals of the U.S. WTI contract is "their" market. ICE is U.S. owned, operated in Atlanta with trading terminals and engines in the U.S. and trading over 30% of U.S. delivered crude oil futures market in U.S. dollar denominated currency.

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[105] § 313(A), Financial Services and Markets Act 2000).

[106] *Developments in financial sector crisis management,* FSA Homepage, available at *http://www.fsa.gov.uk/Pages/About/Teams/Stability/crisis/index.shtml* (last visited July 8, 2008).

[107] Tim Paradis, *Stocks decline in jobs data, surge in oil prices,* ASSOCIATED PRESS (June 6, 2008), available at *http://ap.google.com/article/ALeqM5gHs5OM3gFG_DytQQZFbWfgPT08MAD914K0H80* (last visited July 8, 2008). Goldman Sachs, also one of the founders of ICE, has predicted that the price per barrel of crude oil will surpass $200 by October of this year. Neil King Jr. and Spencer Swartz, *U.S. News: Some See Oil at $150 This Year—Range of Factors May Sustain Surge; $4.50-a-Gallon Gas,* WALL ST. J. (May 7, 2008) at A3; Greenberger, *supra* note 21, at 7.

[108] Jeremy Grant, *ICE restrictions cold comfort for FSA,* FINANCIAL TIMES (June 20, 2008) (emphasis added), available at *http://www.ft.com/cms/s/0/2ba33a0e-3e35-11dd-b16d-0000779fd2ac.html* (last visited July 8, 2008).

[109] Written testimony of Acting Chairman Walter Lukken, *Hearing Before the Senate Appropriations Subcommittee on Financial Services and General Government And The Senate Committee on Agriculture, Nutrition and Forestry* 4 (2008), available at *http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opalukken-41.pdf* (last visited July 8, 2008).

[110] IntercontinentalExchange, Inc., Annual Report Form (10–K) at 63 (Dec. 31, 2007) available at *http://www.secinfo.com/dsVsf.tU7.htm* (last visited July 8, 2008) (showing that ICE's total crude oil futures market share is 47.8%).

[111] Jeremy Grant, *Storm over push for regulatory reform on positions at ICE,* FINANCIAL TIMES (June 20, 2008) (emphasis added), available at *http://www.ft.com/cms/s/0/a00c6a00-3e62-11dd-b16d-0000779fd2ac.html* (last visited July 8, 2008).

However, one could easily see how those officials in the U.K. might mistakenly view WTI trading on U.S. terminals as "their" market when the CFTC and ICE continue to refer to this self evidently "U.S." market as being conducted on a "foreign" exchange. If the CFTC were to flatly state the obvious ( *i.e.,* ICE Futures Europe is wholly owned by a U.S. concern, having brought the corpus of the old British International Petroleum Exchange, for all intents and purposes, to the U.S.). the UK might grasp the reality of the situation, rather than the ICE perpetuated "London" myth.

**Deferring to Foreign Regulators Undercuts the Self Regulatory and Surveillance Requirements of U.S. Law.**

Next to the inability to exercise the extraordinary emergency powers afforded the CFTC to oversee its markets by deferring to the foreign regulators to supervise U.S. energy futures products on U.S. trading terminals, the most serious problem with further CFTC or Congressional deference to FSA is the foregoing of the substantial self regulation and surveillance provided by U.S. regulated contract markets to assist U.S. regulators in policing futures markets.

The "core principles" within the CEA that must be followed by an approved U.S. regulated contract market emphasize the importance having those markets serve as the first line of defense for the CFTC in detecting fraud, manipulation, excessive speculation, and other unlawful trading malpractice.[112] Without aggressive self-policing of the entirety of the regulated U.S. futures markets, the CFTC simply cannot do its job.

The seriousness with which U.S. regulated markets take their statutorily mandated self-policing and surveillance role is evidenced by NYMEX's "standards and safeguards" concerning trade and market surveillance. For example, NYMEX makes clear:

> Market surveillance is required under CFTC regulations. Each day, the compliance staff compiles a profile of participants, identifying members and their customers holding reportable positions. In addition, daily surveillance is performed to ensure that Exchange prices reflect cash market price movements, that the futures market converges with the cash market at contract expiration, and *that there are no price distortions and no market manipulation* . . . .[113]

As to trade surveillance, NYMEX provides:

> Compliance department analysts are trained to spot instances of misconduct, including "front running" or trading ahead of a customer; wash or accommodation trading (transactions creating the appearance of trading activity, but which have no real economic effect); prohibited cross trading (trading directly or indirectly with a customer except under very limited circumstances, or matching two customer orders without offering them competitively); prearranged trading; and non-competitive trading.[114]

NYMEX reports that is has @ $6.5 million budget for oversight market surveillance with an enforcement staff of @ 40 personnel.

No detailed analysis of ICE's self-regulatory and surveillance system is required. Suffice it to say, that for all of ICE's worldwide markets which are accessible by the U.S. trading terminals, including the U.S. WTI contract, reports are that ICE employs no more than ten individuals on its surveillance staff, *i.e.,* a staff that is ¼ the size of NYMEX. This staff monitors trading of a host of ICE contracts, including those contracts which control over 47% of the world crude oil futures.[115] Of course, for those energy futures trades ICE executes under the Enron Loophole (because those trades do not derive from the old-IPE), such as the critical Henry Hub U.S. delivered natural gas futures contract, ICE, as of now, has *no* self-regulation or surveillance system.

Moreover, leaving ICE's paltry surveillance resources to the side, the principal regulator to which the CFTC is deferring to oversee directly over 30% of U.S. delivered WTI contracts, the U.K.'s FSA, has only "two full time supervisors," monitoring all of the ICE contracts under their jurisdiction.[116] Again, this includes 47% of world's energy futures contracts.

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[112] 7 U.S.C. § 7(d)(2)–(6) (2008); (2) (compliance with rules); (3) (contracts not readily subject to manipulation); (4) (monitoring of trading); (5) (position limits); (6) (emergency authority); 7 U.S.C. § 7a(d)(2)–(3) (2008); (2) (compliance with rules); (3) (monitoring of trading).

[113] NYMEX, Enforcement of Exchange Rules, available at *http://www.nymex.com/ss—main.aspx?pg=6* (last visited July 8, 2008) (emphasis added).

[114] *Id.*

[115] *See supra* note 109 and accompanying text.

[116] Grant, *supra* note 108.

In sum, even though the CFTC has ratcheted up ICE's regulatory obligations by adding large trader reporting and speculation limits to the WTI trading, it defers to the FSA for the remainder of the oversight of ICE. In effect, this deference to the U.K. for U.S. trading of the critically important WTI contracts surrenders emergency authority to intervene when there are market dysfunctions to impose temporary margin requirements and position limits; and it sacrifices the real "eyes and ears" policing these markets (*i.e.,* the regulated exchanges themselves) by depending upon ICE's meager surveillance systems.

In a time of economic distress for American industry and the American consumer caused by skyrocketing energy prices, this country cannot afford to outsource authority to the UK to oversee trading on 30% of our own U.S. delivered crude oil futures contracts, much of which is consummated on U.S. based trading terminals and all of which is trade matched in Chicago, Illinois.

Finally, it bears repeating that during last summer's subprime mortgage crisis, Northern Rock PLC, one of the U.K.'s largest banks, was required to borrow billions of dollars from the U.K.'s central bank.[117] After news of the bailout was released to the public, thousands of customers wary of losing their savings stood in long lines for several days outside of Northern Rock's branches to withdraw deposits.[118] With Northern Rock on the brink of collapse, the FSA provided over $100 billion in loans to the bank and in February 2008, the British government finally was required to nationalize it.[119] In March 2008, FSA published an internal report stating that its regulation of Northern Rock "was not carried out to a standard that is acceptable," and highlighted its own failure to provide adequate supervision, oversight, and resources.[120] In addition to FSA's self-criticism, in April 2008, the European Union opened a formal investigation into FSA's restructuring of Northern Rock.[121]

This episode, maybe more than any other, reveals that Congress cannot afford to leave direct oversight of trading on U.S. terminals of the most important futures contract in determining the price of oil, gasoline, and heating oil. As demonstrated above,[122] Congress has the full authority to pass legislation placing those U.S. terminals under U.S. regulatory control.

Threats that the U.S. reassertion of regulatory control over trading within the U.S. will drive trading overseas are undercut by the reality of every major futures foreign exchange having set up shop in the U.S.; and by the well documented law described above that even a foreign trader in a foreign country who illegally disrupts U.S. markets is subject to the full force and effect of that law.

Finally, contrary to the assertion of the City of London Corporation, this is not a "British" market; it is a U.S. market principally being traded in the U.S. by a trading entity controlled by a U.S. corporation. The economic distress now being suffered by Americans over high energy products cannot be placed in the hands of foreign governments when those products are traded here and have such a huge impact on our economy.

The CHAIRMAN. Thank you, Mr. Greenberger.

And I am in receipt of your response. And I, with your permission, will make this available to all the Members of the Committee. Is that okay? And we may have some questions about that. So thank you for being here and your testimony.

Dr. Pirrong, you are on.

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[117] *See Rock Expects* 30bn Loan this Year, BBC NEWS (Nov. 7, 2007), available at *http://news.bbc.co.uk/1/hi/business/7073556.stm* (last visited July 8, 2008).

[118] *See Crisis Deepens for Northern Rock,* REUTERS (Sep. 17, 2007), available at *http://www.iht.com/articles/2007/09/17/asia/17northern.php* (last visited July 8, 2008).

[119] *See* Stephen Castle, *EU to Investigate Northern Rock Nationalization in Britain,* INTERNATIONAL HERALD TRIBUNE (April 2, 2008), available at *http://www.iht.com/articles/2008/04/02/business/rock.php* (last visited July 8, 2008).

[120] *See British Regulator Admits Failings in Oversight of Northern Rock, Announces New Procedures,* ASSOCIATED PRESS (March 26), 2008, available at *http://www1.wsvn.com/news/articles/world/MI81198/* (last visited July 8, 2008).

[121] *See* Castle, *supra* note 119.

[122] *See supra* notes 41–60 and accompanying text.

**STATEMENT OF CRAIG PIRRONG, PH.D., PROFESSOR OF FINANCE AND DIRECTOR, GLOBAL ENERGY MANAGEMENT INSTITUTE, BAUER COLLEGE OF BUSINESS, UNIVERSITY OF HOUSTON, HOUSTON, TX**

Dr. PIRRONG. Good morning. I am Craig Pirrong, Professor of Finance and Energy Markets Director of the Global Energy Management Institute at the Bauer College of Business at the University of Houston. I deeply appreciate the Committee's invitation to speak at this hearing, and hope that what I have to say will contribute to the formulation of a prudent legislative response to current conditions in the energy market.

Before I begin, I should say that what I have to say is my opinion alone and does not necessarily reflect the views of UHGEMI or the University of Houston more generally.

I should probably start by telling you a little bit about myself. I have been intimately involved in the commodity markets and the derivatives markets for over 22 years as an investment analyst, a teacher, a researcher, a consultant, an expert witness in commodity market litigation. I have particular expertise in the economics of market manipulation, having published what is probably more than any academic has on the subject over the past 15 years or so. In addition, I have extensive practical experience in studying manipulation in my roles as a forensic economist and a consultant to exchanges in the United States, Canada and Europe.

Although I have studied commodity markets and especially energy markets as an academic researcher, my practical experience in one specific area is particularly germane to the issues before the Committee and the Congress, generally. Specifically, that is my experience in evaluating the delivery mechanisms at various commodity exchanges, and my participation in the design of contract delivery mechanisms for several exchanges, most notably the Chicago Board of Trade.

Understanding the delivery process and its role in commodity markets is critical to understanding the key issues in the ongoing debate over the role of speculation and the role of OTC markets and energy. The most important lesson is that although it is commonplace to speak of the oil market or the corn market, there is, in fact, a web of closely related but distinct markets, each of which performs different functions or serves different customers. The most important distinction is between the market for a physical commodity and the market for derivatives on that economy. The delivery mechanism links these markets, but to understand how to design a delivery process, you need to understand how these markets perform, how they relate to one another and what very different functions they perform.

They need to work together efficiently, but one market is not a perfect substitute for another. Moreover, there are multiple markets even within the broader category of derivatives. Exchange-traded and OTC instruments are substitutes in some respects, but imperfect ones in others, and serve different categories of users. Moreover, these markets are also complementary to some degree.

When an American motorist digs into his or her pocket to pay for gasoline, the relevant market is the market for physical oil, and the price that is relevant is a spot price for a wet barrel. The price,

or the role of these physical markets, is to facilitate the flow of physical oil from producer to refiner to consumer, and the role of prices in these markets is to provide the scarcity signals that guide these physical barrels to their most efficient use.

Derivative markets, both exchange-traded and over-the-counter, are primarily markets for transferring risk and discovering prices. The supplier of oil can hedge his price exposure by selling a futures contract. A buyer of oil, an airline for instance, can hedge against a price increase by buying an over-the-counter swap. Neither the oil producer nor the oil buyer is likely to use these future contracts or the swap to obtain ownership of physical barrels. Indeed, in the OTC contract this is usually impossible. Instead, these market participants use the traditional physical market to obtain or sell their physical energy and use the futures or swap markets to manage the price risks inherent in their activities as producers or consumers of energy.

The risk that a producer or consumer sheds doesn't disappear. It must be transferred to somebody else. That somebody is often, for a time at least, a market participant who can be characterized as a speculator, someone who takes on price exposure with the intent of earning a profit, at least on average. This entity could be a dentist in Iowa, or it could be a large financial institution. Risk transfer is the very reason that derivatives markets exist, and since speculators play a vital role in the risk-transfer process, unnecessarily burdensome constraints on speculator participation undermines the ability of these markets to perform their role. And make no mistake about it, such restrictions will adversely affect, and detrimentally, the ultimate consumer of energy. Firms wish to reduce the cost of bearing risk. If you make it more difficult for them to hedge by restricting speculation, you will make it more costly for them to do so, and those higher costs will be passed on to consumers.

The concern over the speculation in derivatives markets including the OTC markets is based on a belief that speculation somehow distorts the physical market for oil and the prices for physical energy that consumers pay. The basic argument is something like speculators are buying billions of dollars of oil derivatives. Their buying is equivalent, but not greater in volume, to the increase in demand from rapidly growing markets such as China. These purchases represent demand for oil; and hence they drive up prices.

This argument ignores the very fundamental distinction that I just discussed, the distinction between the physical and the derivatives markets. By ignoring this distinction, those making this argument fail to answer the crucial question: What is the channel by which speculative buying in derivatives markets is communicated to the physical market?

I think it is very important to note, and I think if there is one major takeaway from here, is that if excessive speculation or manipulation is distorting prices, that will become manifest in what goes on in the physical market. You will see distortions in the amount of inventories, or you will see distortions in the flows of oil in the interstate and in the international markets.

To date, nobody, to my mind, has brought up any credible evidence that these distortions exist, and given such absence of evi-

dence, there is really no firm basis to believe that there is anything in the order of excessive speculation or manipulation that is causing oil prices to be $140 or $130 or $135 per barrel.

So I think that the key thing is, going forward we shouldn't just look at prices, we should look at the real market for oil. We should look at the physical market as well as the derivatives market, understand the linkages between these two markets, and proceed in a prudent and considered manner, because intemperate or ill-thought-out actions to constrain speculation could have very adverse effects on the operations of both the physical and the financial markets.

Thank you.

[The prepared statement of Dr. Pirrong follows:]

PREPARED STATEMENT OF CRAIG PIRRONG, PH.D., PROFESSOR OF FINANCE AND DIRECTOR, GLOBAL ENERGY MANAGEMENT INSTITUTE, BAUER COLLEGE OF BUSINESS, UNIVERSITY OF HOUSTON, HOUSTON, TX

I am Professor of Finance, and Energy Markets Director of the Global Energy Management Institute at the Bauer College of Business at the University of Houston. I have been actively involved in the commodity markets for the 22 years. I have published numerous articles and two books on commodity market issues; these include several articles on energy prices and energy trading. Moreover, I have taught courses in futures markets, financial markets, and energy markets at the graduate and undergraduate level. I currently teach a course in energy derivatives for a Global Energy MBA program in both Houston and Beijing. Furthermore, I am a member of the CFTC Energy Market Advisory Committee and the CFTC Technology Advisory Committee.[1]

The subject of market manipulation is a special area of expertise. I have published seven articles and a book on the subject, and have testified as an expert in several high-profile manipulation cases. I have also given a 2 day seminar on manipulation to the staff of the Federal Energy Regulatory Commission.

In addition to my academic research in commodity markets, I have served as a consultant to several exchanges. In this role, I have participated in the design of commodity futures contracts in the United States, Canada, Sweden, and Germany. I also was the primary investigator in a study (commissioned by a major energy consumer group) of the impact of increases in speculative position limits on the volatility of natural gas prices.

Based on my extensive study of, and experience in, commodity and commodity derivatives markets and market manipulation, I offer this testimony on the role of speculation and manipulation in affecting energy markets, and the likely impact of restrictions on speculation in these markets.

High prices for petroleum products impact American consumers in every aspect of their lives. The direct consequences—higher prices at the gas pump—are readily apparent, but oil prices affect the cost of manufacturing and/or transporting virtually everything one buys, so the indirect consequences of high prices are important too.

Given the salience of this issue, it is appropriate for legislators and regulators to attempt to determine the causes of high prices for oil and other energy products, and to craft the appropriate policy responses. One factor—speculation in energy products—has received intense scrutiny as a potential cause of high prices. The widespread belief that speculation is causing oil prices to rise far above—some say as much as $70 dollars/barrel above—the appropriate level has led to numerous proposals in both the House and the Senate to reduce speculation in energy markets.

Although I will touch on some pending and proposed legislation, I will focus my analysis on the role and impact of speculation generally. This analysis implies that anti-speculation efforts are misguided and should be avoided, rather than implemented.

In my opinion, speculation is not the cause of high prices for energy products; the arguments advanced in support of this view are logically defective and at odds with

[1] The opinions expressed herein are exclusively my own, and do not reflect the views of the Global Energy Management Institute, the Bauer College of Business, the University of Houston, or the CFTC.

an understanding of how the markets work. Most importantly, there is no evidence to support claims that speculation—or manipulation for that matter—is responsible for high energy prices.

To the contrary, speculation plays a constructive and important role in price discovery and the efficient transfer of risk. As a result, restrictions on speculation like those proposed of late will not alleviate price pressures, but will reduce the efficiency of the energy marketing system. Such a move would set the stage for a raft of unintended consequences that may be not only damaging to consumers and businesses in the U.S., but to the global economy, in which oil, no longer just a "U.S. commodity", plays a significant role. New markets are forming across the globe[2] and capital will flow to where it is least constrained by counterproductive regulations. Today that is the U.S., but this is not guaranteed if Congress imposes unduly restrictive burdens on participants in U.S. markets. Therefore, Congress would be well-advised to avoid implementing rash measures to reduce speculation, and to focus instead on policies that encourage increases in output and efficient uses of energy.

More specifically:

- In recent debates over energy prices, the word "manipulation" has been thrown around with abandon. There are numerous allegations that manipulation by speculators is what is causing the current high prices. Indeed, one of the bills currently under consideration is called "The Prevent Unfair Manipulation of Prices Act" ("PUMP.") However, price behavior in the oil market during the recent period of dramatic price increases is **not** consistent with manipulation.
- I base this conclusion on my extensive research on derivatives market manipulation; indeed, I have published more (numerous articles and a book) on this subject than any academic economist. Moreover, I have designed futures contracts with the specific objective of minimizing their vulnerability to manipulation, and as a result, have extensive practical experience in how manipulation works and how it can be prevented and deterred.
- In my research, I have found that the term "manipulation" is often used loosely. Indeed, this is true of discussions of the energy market today, some of which remind me of what a Texas cotton trader said during testimony before the Senate in 1923: "The word 'manipulation' . . . in its use is so broad as to include any operation of the cotton market that does not suit the gentleman who is speaking at the moment."[3]
- Certainly there are forms of conduct-notably a "squeeze" or "corner"—that are properly considered manipulative. My research demonstrates that such manipulative acts have distinct effects on prices, price structures (*e.g.,* the relation between nearby and deferred futures prices), and the movements of physical commodities in interstate and international trade. These effects have **not** been observed in the oil market during 2007–2008. Moreover, existing regulatory and legislative remedies, if employed vigorously and precisely, are sufficient to address potential future manipulative attempts. Policymakers would be well advised to utilize existing tools to fight recognized forms of manipulation, rather than implement new policies that will not appreciably reduce the frequency and severity of real manipulations, but which will interfere with the ability of the markets to discover prices and transfer risks efficiently.
- Constraining the positions that market participants can hold can reduce the frequency of market power manipulations, but such position limits are an inefficient tool for achieving this objective. They are inefficient because they limit the ability of speculators to absorb risk from speculators and are difficult to set at a level that is sufficient to make it difficult to corner a market without unduly constraining the ability of the markets to transfer risk efficiently.
- Based on long study and involvement in the derivatives markets, I believe that corners and squeezes are a serious concern—and not just in energy markets, but in financial and other commodity markets as well. I further believe that corners and squeezes should be punished severely, either through criminal or civil penalties, or private litigation. That said, I emphasize that: (a) there is no evidence that manipulation properly understood explains the current high prices for energy products, or (b) that position limits are not the most efficient or effective means of reducing the frequency and severity of manipulation.

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[2] As a recent example, the Hong Kong Futures Exchange just announced its plans to launch energy futures trading.

[3] *Cotton Prices: Hearings Before a Subcomm. of the Senate Comm. on Agriculture and Forestry, Pursuant to S. Res. 142,* 70th Cong., 1st Sess. 154 (1928).

- Moreover, there are more efficient tools than position limits available to deter corners and squeezes. These kinds of manipulation are already illegal in both the futures and OTC markets. Moreover, these types of manipulations can be detected with a high degree of precision; as Judge Frank Easterbrook (5th Circuit Court of Appeals) has written, "an undisclosed manipulation is an unsuccessful manipulation."[4] Since corners and squeezes are detectable, and those that carry them out are usually not judgment proof, it is more efficient to deter manipulation by imposing penalties after the fact on those that engage in this conduct (through criminal or civil penalties, or private litigation) rather than by constraining the activities of all market participants before the fact through position limits.
- Vigorous head-to-head competition between similar futures contracts is a distinct rarity. The ongoing battle between NYMEX and ICE WTI contracts is one of the very few examples of such competition in the global futures markets. Competition generally redounds to the benefit of market users, and should be encouraged. Any regulatory or legislative change that would impair the direct access of U.S. customers to ICE Futures Europe would either be ineffectual because global financial institutions would merely shift their business to London, or counterproductive because it would reduce competition in the WTI market. Though the London-based exchange has only a 15% share in the WTI crude market, it represents a tool for global energy producers and banks to manage risk using a cash-settled instrument, rather than in a physical oil contract. Moreover, such measures would not materially reduce the vulnerability of the oil market to manipulation. Such measures would, therefore, create costs without producing any corresponding benefit.
- Historically, major shocks to commodity markets have been blamed on speculators, and speculative excess. The response to the current oil price shock is no exception. Assertions that speculation by financial institutions, including investment banks, hedge funds, commodity funds, and pension funds, have inflated oil prices by as much as $70 per barrel are logically defective and completely unsupported by any reliable evidence. Almost without exception, trading by these market participants does not contribute to the demand or supply of physical oil, and hence their trading does not distort the physical oil market. Many financial institutions trade cash-settled derivative instruments, including swaps and the ICE WTI contract, which cannot be used to take or make delivery of oil; nor can these positions result in a physical claim on oil. Those trading these instruments are by definition price takers, not price makers. Moreover, even when financial institutions trade delivery-settled instruments, such as the NYMEX WTI contract, they typically offset their positions prior to the delivery period, and hence do not contribute to the demand or supply for physical oil. Even if they purchase in large amounts, they subsequently sell in almost equal amounts as contracts reach delivery. Hence, they typically exert no upward impact on the "spot" price for oil which is crucial in determining the prices that consumers actually pay.
- It should also be noted that the oil market has not exhibited one of the necessary indicia of speculative distortion of prices—the accumulation of large and increasing inventories in the hands of speculators. Attempts to hold prices above their competitive level—such as the actions of the Hunts in the silver market in 1979–1980, or the International Tin Council, or the agricultural price support programs of the U.S. Government in years past—require the entity keeping the prices up to accumulate large inventories. This has not been observed in the oil markets of late.
- With regard to the notion that passive investors (including "long only" index funds) have dramatically impacted the price of oil, there are some key factors that prevent this from being the case. Most notably, commodity index funds buy and sell in equal amounts on a regular basis as the futures contracts expire on a monthly or quarterly basis during the "contract roll." Because they roll, they do not take delivery, and hence do not affect the demand for physical oil. Indeed, they are *sellers* as futures contracts near delivery, and hence are not the source of any buying pressure in the physical market; if anything, the reverse is true.
- This phenomenon has been long understood. In 1901 (!) a report from the United States Industrial Commission on "The Distribution of Food Products" stated:

[4] Frank Easterbrook, *Monopoly, Manipulation, and Fraud,* 59 J. OF BUSINESS (1986), S107.

> As we have attempted to show, it is a mistake to represent speculation in futures as an organized attempt to depress prices to the producers.
>
> First. Because every short seller must become a buyer before he carries out his contract.
>
> Second. Because, so far as spot prices are concerned, the short seller appears as a buyer not a seller, and therefore, against his own will is instrumental in raising prices.[5]

The concern addressed by the Industrial Commission was the mirror of today's: in 1901, it was widely alleged that speculative short selling depressed the prices of corn, wheat and oats, whereas today it is asserted that speculative buying inflates the price of energy. The Commission's analysis is directly on point nonetheless; speculators who offset their positions (short sellers who buy futures, or buyers who sell them) do not distort spot prices—the prices that consumers pay and producers receive.

- Of note, what many experts claim are massive inflows to commodity index funds over the decade is largely the price appreciation of the assets in the commodity index rather than "new money". The assets attributable to commodity index funds represent a small portion of these aggregate markets. Interestingly, in the markets where index funds are most concentrated, such as the cattle futures markets, prices have been flat. Wheat futures traded on the Minneapolis Grain Exchange are **not** included in an index, but have experienced dramatic increases in price. Finally, these index funds take no supply off the market, thus do not impact the physical market where spot prices are set.
- It has been asserted that oil may be in a speculative bubble. However, speculative bubbles are less likely to occur in the market for a physical commodity, than a market for financial assets, such as growth stocks in new industries. The discipline of physical delivery that connects derivative instruments—such as futures contracts—to the market for the physical commodity makes it far more difficult for commodity prices to become untethered from fundamentals as in the case for Internet stocks, to name but one example. Moreover, extant economic research suggests that goods and assets with active futures contracts are actually less susceptible to bubbles than those lacking liquid futures markets. Hence, it would be particularly misguided to attack an alleged bubble by impeding the trading of oil derivatives. Finally, economic models of speculative bubbles imply that during a bubble, futures prices should exceed spot prices by the cost of carrying inventory; this was not observed during the period of rapid oil price increases in recent months.
- Some proposed legislation is intended to constrain the ability of financial institutions such as investment banks, pension funds, and index funds, from participating in the commodity markets. Such efforts are misguided because the participation of financial institutions in the commodity markets in general, and the oil market in particular, is a laudable development. Improved integration of the financial and commodity markets facilitates the efficient allocation (and pricing) of commodity price risk. That is, it facilitates hedging by energy producers and consumers, which in turn helps consumers; pension funds and index investors can often bear risk more cheaply than others (because of their ability to diversify), and hence their participation in the market reduces the cost that hedgers incur to shed this risk. Moreover, by trading commodity derivatives, including exchange traded commodity futures, investors can improve the performance of their portfolios by reducing risk without sacrificing return—and without putting claims on physical inventories. Indeed, this very ability to improve portfolio performance is what permits these investors to take on risk from hedgers more cheaply Therefore, impeding the ability of financial institutions and investors to utilize the futures markets would harm hedgers and investors, again without generating any benefit for American consumers of oil products in the form of lower prices.
- Moreover, some speculators devote effort and resources to researching market, geopolitical and seasonal fundamentals. Their participation in trading ensures that the information they produce is incorporated in prices. Such trading facilitates price discovery, contributes to the informational efficiency of prices, and thereby encourages efficient use of scarce energy resources by providing producers and consumers with more accurate measures of the true value of oil.

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[5] *Report of the Industrial Commission on the distribution of farm products* 223 (1901). Many Members of the House and Senate were members of the Industrial Commission.

- The role of margins in futures markets is to ensure that parties to futures contracts are willing and able to perform on their contractual commitments; in essence, margins are performance bonds (collateral). Margins have costs; they require traders to hold more in low yielding assets (such as Treasury bills and cash) than they would absent such margin requirements. Exchanges, clearinghouses, clearing members, and brokers have incentives to set margins efficiently to trade-off these benefits and costs. Exchanges and clearinghouses use sophisticated methods to set margins efficiently, and based on these methods, adjust margins to reflect changes in price volatility.
- It would be imprudent to increase margin levels dramatically by regulatory or legislative fiat to choke off speculative activity in the energy markets. There is no reliable empirical evidence that margin increases reduce price volatility, or reduce disparities between market prices and prices justified by fundamentals. Changes in margins would affect both long and short speculative activity, and hedging activity, and thus could lead to either increases or decreases in futures prices relative to expected spot prices. Moreover, raising the cost of speculation through margin changes would tend to reduce market liquidity and increase the costs of hedging. Furthermore, raising margins affects the activity of market participants based on how much cash they have—not how much information or smarts they possess. In addition, raising margins on exchange traded instruments is likely to encourage a migration of trading to off-exchange venues where parties can freely negotiate collateral levels. Even if speculation was distorting prices—and I repeat that there are neither convincing evidence nor arguments to support this view—regulation of margins would be an extremely blunt tool to control speculation, and would likely have detrimental effects on the efficiency of the futures market as a hedging and price discovery mechanism.
- Over-the-counter ("OTC") instruments play an important role in virtually all financial and commodity markets. Indeed, the volume and open interest of OTC contracts is typically higher than corresponding figures for their exchange traded counterparts. Like exchange traded futures, OTC swaps permit hedgers and speculators to trade risk efficiently. Revealed preference indicates that for many market participants, OTC swaps and options offer advantages over exchange traded instruments. That is, market participants can often achieve their risk management objectives more efficiently using swaps than using exchange traded instruments. OTC market participants are already proscribed from manipulating any commodity traded in interstate commerce, so it is incorrect to say that these markets are unregulated. Additional regulation, such as limiting participation in OTC energy markets to those capable of making or taking delivery of an energy commodity, or to those who produce it, would interfere with the ability of these markets to perform their essential risk transfer function without materially reducing the frequency of manipulation. OTC markets facilitate the trading of risk, and many of the most efficient bearers of risk are not the most efficient handlers of the physical commodity. Indeed, since most OTC contracts are financially settled, they cannot even be used to transfer ownership—they are used exclusively to transfer commodity price risks. Limiting participation in these markets to those who produce, consume, or otherwise handle, the physical commodity therefore largely defeats their very purpose. By eliminating from the market those who can most efficiently bear risks, such measures would make hedgers—who do handle the physical commodity—worse off.
- In evaluating the role of energy speculation, and energy derivatives markets more generally, it is imperative to remember one crucial fact: derivatives markets are first and foremost markets for risk, rather than markets for the actual physical product. Derivatives markets effectively permit the unbundling of price risks from the actual physical commodity. It is this unbundling that makes hedging work. The derivative market for oil and the physical market for oil are of course related, and indeed, the delivery process in the futures market ensures that futures prices at maturity reflect the actual value of physical energy. As long as the integrity of the delivery process is protected against the manipulative exercise of market power, however, financial trading of energy derivatives permits efficient allocation of energy price risks, but does not impede the orderly and efficient operation of the market for physical energy. Indeed, by facilitating the efficient allocation of risk and the discovery of prices, derivatives trading—including derivatives trading by speculators, investors, and financial institutions—actually makes the physical market more efficient. It allows energy producers and consumers to shift the risks to those best suited to bear them, and to focus their efforts on producing, transporting, marketing, and

using energy as efficiently as possible. This benefits energy consumers in the U.S.

In summary, energy derivatives markets play an important risk transfer and price discovery role. Speculation is a crucial element of an efficient derivatives market; speculators provide services that redound to the benefit of producers and consumers of energy looking to reduce risk, and hence to the customers of those producers and consumers. Assertions that manipulation, or speculation, or manipulative speculation, are causing high oil prices are not based on sound economic reasoning, and find no support in the data. Policies based on such mistaken beliefs will do nothing to alleviate energy price pressures. Indeed, such policies are likely to harm U.S. consumers and investors by impairing the ability of the energy derivatives markets to discover prices and transfer risk.

The CHAIRMAN. Thank you very much.

Mr. Zerzan, for the benefit of the Committee, would you tell us what a swap looks like? I mean, is it an actual contract? Can you send us a copy of one of these so we can see what it looks like? Are they all kind of alike, or are they different?

What I am trying to understand is exactly—I think there is confusion on the part of Members and myself about just what this is, and I don't think they are all alike. Some people are doing these swaps that actually are in the business, and then you have people that rather than go to Las Vegas, they deal with you guys apparently. So as somebody said, "The problem is we don't know what is what here." But could you explain to us how this works?

And then, as I understand it, these swaps mostly are offset with some over-the-counter offset, and they net these things out before they end up going over to the NYMEX. Could you just explain that maybe in terms that the Committee would understand?

Mr. ZERZAN. Sure. Your typical over-the-counter derivative arrangement has essentially three parts. The first part is what is called a master agreement, and it defines the scope of the relationship. So let's say I am ABC investment bank, and on the other side I have XYZ airline. XYZ airline wants to hedge its risk of the rise in prices or the fluctuations in the price of jet fuel. So, the investment bank and the end-user will enter into a master agreement which defines the overall contractual terms; what happens in the case of a default; what happens in the event that some of the parties to the transaction decide they want to enter into other transactions.

So under the master agreement you then have a credit support document, and the credit support document outlines the collateral between the transactions, between the parties. If I am going to enter into a relationship with a counterparty, I want to know that if they back away, I have some security, I have some sort of recourse. And so we will have a credit support annex which defines the type of collateral which I can try to obtain if my counterparty decides it is going to walk away.

Any individual transaction, like the swap that I want to do with the airline, is documented by a confirmation, and each individual transaction is confirmed via a confirmation. All of these are written contracts. And we will be happy to provide the Committee with examples of these. They are written contracts. They are generally referred to as ISDAs within the trade, because ISDA developed the general framework.

But within the context of the actual documents, the material economic terms are always negotiated. These terms include, obviously,

the price, the size of the transaction, such things as I mentioned: the collateral; what type of collateral must be posted; and what events would constitute a default under the contract, for instance. So although you have standardization in terms of the framework, the actual terms of the agreement that relate to the actual transaction, the economic exposures, are all individually negotiated, and they are, in the case of each transaction, confirmed by a written confirmation, which is a contract like any other contract.

The CHAIRMAN. Well, and are these normally just by themselves, or are sometimes a bunch of these put together and then offset by some other institution that picks up that risk, or does one of these credit default swaps—or is that—how does that work?

Mr. ZERZAN. If I am a swap dealer, I will have transactions with XYZ airline, ABC trucking company, CDF producer. And this gives me an overall net portfolio exposure. So as opposed to my trying to seek to offset each individual transaction, I will try to offset the exposure in my entire portfolio, and I may go to the futures market to do that. In fact, I will likely go to the futures market to try to offset some of that exposure. But this is done primarily as a means of risk management.

And so when we talked about the hedge exemption, you can see, if you are an investment bank, you have a very real need to hedge your risk by going to the futures market as part of managing your overall portfolio, and that allows you to enter into contracts on commodities like jet fuel that an airline can't otherwise obtain protection on.

The CHAIRMAN. Well you have airlines and truckers and so forth; they have a business of being in the market. But we have these other people that apparently buy these things that have no interest in ever owning oil or have no connection to this at all. They are just apparently getting into this because they think they can make money. Am I right?

Mr. ZERZAN. Well, you have people that are speculating certainly.

The CHAIRMAN. Yes. And one of the problems is the CFTC doesn't know how many of these contracts relate to actual physical hedgers and how many are speculators, I guess. Do you have any idea what that percentage is, how many of these swaps are airlines and truckers and people that use this stuff and how many aren't? And how much of the hedging is in the actual futures market, and how much of it is in the over-the-counter market? Do you have that information?

Mr. ZERZAN. Well, one of the proposals that has been put forward would require the disaggregation and the breaking down of swap dealers and index traders and others. To the extent that the Commission feels that that type of transparency is important; and Congress feels that that should be done, then I think the important thing to remember is you don't want to create a situation where an individual swap dealer's strategy or position in the futures market is laid open so that other traders can trade ahead. And one of the concerns that have been expressed is that you want to make sure you anonymize the ability of individual firms to use the futures market to hedge their *bona fide* risk.

When you ask what is the percentage of people doing speculative trades *versus* what is the percentage of people that are doing hedg-

ing trades, I actually think that would be tremendously difficult to try to break out on any case-by-case basis. On any given transaction, you might have a party that is hedging one part of its portfolio. You might have another party that is speculating. You might have an individual transaction that in some light is seen as speculation and in another light is seen as a hedge.

The most important question is whether or not the speculation is driving up the price of the commodity. And I think that Professor Pirrong noted there is no real evidence showing that is the case.

The CHAIRMAN. Well, and if the Committee will bear with me, I just want to finalize this. So these guys don't want to know, they don't want anybody to know what they are doing. I can understand that. That has been part of my puzzle about all of this. And from what I can tell, some of these swaps and these index funds are never, ever getting over into the futures market. The only thing that is getting over there is the amount that you can't lay off over-the-counter some other way. So people are basically making this side bet over here between two parties, and in the case of the indexes, they are using the futures market as what they are betting against. But this money never goes into the futures market. And if nobody knows what they are doing, how can it affect the price?

That is what I cannot figure out. I mean, if the money doesn't go in there, and if nobody knows what they are up to, then how can it affect the price? The part of it that goes over into the futures market could potentially affect the price, but I just don't get the connection here. Am I missing something; or does somebody actually know what these swap things are, and then they use that information?

Mr. ZERZAN. No, Mr. Chairman, I think you hit the point precisely on the head. An individually negotiated contract between two people, the price of which is known only to those two people, doesn't affect any price of anything else. And to the extent that you have swaps that are then being hedged in the futures market, as you point out, that pricing information is being fed into the futures market, and it is showing up in the price of the contract.

But you have hit the issue precisely. These are not driving up prices if they are contracts which are bilaterally negotiated and the prices are known only to the two people to the transaction.

Mr. MARSHALL. Mr. Chairman.

The CHAIRMAN. Mr. Marshall.

Mr. MARSHALL. Would you mind?

The CHAIRMAN. Yes.

Mr. MARSHALL. I just wanted to follow up on something that you have already raised as a result of Mr. Zerzan's comment concerning the problem with more transparency in this market. And it is, in essence, as you described it, a worry by those who are trying to hedge in the market that others will be able to trade ahead of them. And what you mean by that is if word gets out that XYZ airlines is working with ABC to cover a particular risk. Where jet fuel is concerned, ABC's costs go up if ABC knows that it is going to be more difficult for it to then lay off that risk someplace else because the word gets out that it is going to be trying to do this. This is a huge position that will have to be taken, and consequently peo-

ple get there ahead of time, and it becomes more expensive for them to lay off the risk. Is that basically the concern?

Mr. ZERZAN. Yes, sir.

Mr. MARSHALL. I am describing this adequately?

There wouldn't be a problem with sharing information concerning the swap position confidentially with the CFTC to enable the CFTC itself as a regulatory entity to have complete transparency in real time with regard to what is going on in the market. Wouldn't that be correct, because that would have no effect on somebody trading ahead?

Mr. ZERZAN. Well, for instance, your legislation where you put forth the provision where swap dealers would be required to report separately, I don't think that type of reporting would be something that the firms would be unprepared to do. I think they already have those records, and they would be able to do so. And as you point out, the important issue is that it is done in such a way that it doesn't individually point to each firm's trading strategy.

Mr. MARSHALL. So the effect of adopting a rule like that would be to increase the oversight burden for the CFTC for sure, because they would be receiving all kinds of information which they could probably arrange to receive in summary form, in addition to the detail, but also in summary form. This is pretty close to whatever it is on NYMEX, something like that. To generally follow what is going in the market with a fair amount of ease, CFTC may need a little more resources, but the market itself wouldn't react badly to that as long as the market had confidence that this information was going to remain secret. And, so, you wouldn't have this problem of people trading ahead and consequently making it more expensive to hedge.

And in addition, frankly, having a regulatory regime where there is a regulator that is seeing all of this could enhance the confidence that people have in the market and be good for the market as opposed to bad for the market, wouldn't you think, Mr. Zerzan?

Mr. ZERZAN. Again, I think it is important that we are clear, when we are talking about a provision that shows the over-the-counter positions as opposed to the futures positions, then you are talking about a different regime. What your legislation does is it talks about showing the hedges in the future markets, broken down by the fact they are done as a hedge on a swap.

Mr. MARSHALL. And my question goes further than that.

The CHAIRMAN. Mr. Marshall, we are way over my time, so I recognize the gentleman from Virginia, the Ranking Member, Mr. Goodlatte.

Mr. GOODLATTE. Thank you, Mr. Chairman. And I want to thank all the members of the panel.

Dr. Pirrong, yesterday we had a panel of witnesses who were Members of Congress who have introduced legislation that they believe would address some of the concerns that have been raised regarding speculation in the futures market. One of those witnesses used the Hunt brothers' attempt to corner the silver market as an example of what is happening today. And I wonder if you could compare and contrast what the Hunt brothers did *versus* what we observe in energy and commodity markets today.

Dr. PIRRONG. I will be glad to, sir. In fact, I think that that is sort of an excellent example of how things are very different today from what happened with the Hunts or other examples of manipulation that have happened in the past. And in particular, it relates to a point that I raised during my initial statement, which is relating to if manipulative acts or speculative acts are distorting prices, you are going to see distortions in the physical market.

The basic idea is prices send signals about scarcity. People respond to price signals and do things with real things in response to that. If you screw up prices, you are going to screw up the allocation of resources, and you are going to see that very clearly.

In the case of the Hunts, they amassed a massive position in silver and started taking deliveries of huge quantities of silver. Indeed, there are sort of anecdotal stories about brides in India melting down their *trousseaux* of silver to have them shipped to New York because the price of silver was so highly distorted that it was better to have the Hunts sit on it than to have it as part of their trousseau. There was a clear evidence in the physical market that something was wrong and that prices were distorted.

What you would look for today is sort of evidence of the same sort of thing. You would look for evidence of oil, in this instance, being accumulated, hoarded by speculators. You should see an elevation in the level of oil inventories or oil stocks, and there is no evidence that we see of that. And so that is a very important thing. You just can't look at prices alone.

Let's look at the real side of the economy, too. Let's look at quantities as well as prices. Every economist, when he puts up a supply and demand diagram, there are two axes. There is a price axis, but there is also a quantity axis. If speculation is distorting prices, we will see that in some sort of quantity data, like in inventories or in flows of the commodity. We saw that with the Hunts. We don't see it now.

Mr. GOODLATTE. Well, let me ask you about that inventory. It was widely reported this week that the U.S. Energy Information Administration said that for the week of July 4, domestic crude stocks fell 5.9 million barrels to 293.9 million barrels, the lowest since the week of January 25 when stocks stood at 293 million barrels. Is this information consistent or inconsistent with what you, as an expert, would expect to observe if there were efforts to manipulate the market?

Dr. PIRRONG. No. What we would expect to observe if the market was being manipulated is that stock should be increasing, that we should see hoarding. Stocks should see ballooning, not declining.

Mr. GOODLATTE. Thank you.

Mr. Greenberger, yesterday we heard testimony from Members of Congress that support legislation that would address many of the issues of concern that have been voiced by you and others. You and others have cited hedge exemptions as a way for parties to increase their speculative positions. The CFTC made data available to us that allows us to analyze this.

In 2006, for swap agreements, 19 firms requested hedge exemptions. Thus far in 2008, only four firms have requested hedge exemptions, one on an annual basis and three temporary. For a combination hedge and swap agreements, 23 firms requested hedge ex-

emptions in 2006. Thus far in 2008, eight firms have requested hedge exemptions. For pure hedges, ten exemptions were requested in 2006 and only two in 2008. During the time that crude oil had a large run-up in price, the request for hedge exemptions has fallen dramatically. How do we reconcile that data with what we are hearing?

Mr. GREENBERGER. Thank you. I am happy to answer that question. First of all, the relationship between hedge exemptions and the skyrocketing speculative investments, you will only need one hedge exemption. If Goldman Sachs has a hedge exception, they are going to enter into the markets billions of dollars under that exemption. So I don't think the number of hedge exemptions tells you anything.

Second, the Chairman asked a very interesting question.

Mr. GOODLATTE. Well, you said it in your testimony that hedge exemptions were a way for parties to increase their speculative position.

Mr. GREENBERGER. Yes. And I say if Goldman Sachs——

Mr. GOODLATTE. But that is not apparently how they are doing it now, if there are only a few.

Mr. GREENBERGER. I am saying if you only have one, if Goldman Sachs has one, that is all they need.

Mr. GOODLATTE. Is Goldman Sachs responsible for this large run-up?

Mr. ETHERIDGE. Would the gentleman yield?

Mr. GOODLATTE. I would be happy to yield.

Mr. ETHERIDGE. I am told that the very day that they offer the exemptions, the stock of oil will fall, which doesn't square with the fact that if you have an exemption it should be going up, shouldn't it?

Mr. GREENBERGER. Let me answer that question as well. The Chairman put his finger on the pulse of the issue. He says, "Gee, I don't see all this money going to NYMEX." Now, if it goes to NYMEX, the concern has been that when Goldman Sachs tries to take its short positions from its swaps and convert them into longs, they are buying long on NYMEX. The hedge exemption is allowing them to be treated as an oil dealer rather than as an investment bank who is laying off its risk from all the bets it has taken in on the price.

Now, you have to understand when Mr. Zerzan says they are netting things out, it is like a bookie. They have longs, they have shorts, and they see how much overage they have. When they have a lot of overage they have sold short to the people who are buying long. And that is not a good way to be in this market. So they have to find other avenues to lay off that short risk and buy long.

Now, the Chairman says, "Gee, I don't see all that on NYMEX." They don't need a hedge exemption to lay that off on the over-the-counter market. The over-the-counter markets are not covered by hedge exemptions.

Now, if I can just follow my train of thought, Mr. Goodlatte.

Mr. GOODLATTE. Yes. My time has expired. I do want to give Dr. Pirrong an opportunity to respond as well. But go ahead.

Mr. GREENBERGER. Okay. When they go out into the over-the-counter market, everybody is saying, "Gee, we don't know what is

happening in the over-the-counter market. So how can it affect the price of crude?" Well, what is happening in the over-the-counter market is Goldman Sachs is going to people, asking them to sell short. And that is all happening in the over-the-counter market, which as Congressman Marshall is saying, "We don't have any information about." Well, those shorts are being sucked out of transparency. So if you look at NYMEX, all you are seeing is the long, the heavy long position on NYMEX. You don't see everybody who is selling short on the over-the-counter market. If those shorts were required to be on NYMEX or another regulated exchange, you then all of the sudden would see that people want to sell here, they just don't want to buy.

Mr. GOODLATTE. Let me ask Dr. Pirrong if he agrees with your assessment.

Dr. PIRRONG. No. Essentially this is just part of the process where essentially risk is being allocated and essentially in an efficient way. These markets are intimately interconnected. To the extent that a swap dealer sees order flow, he has the ability to trade that off in many markets. And to the extent that the impact of that order flow isn't reflected on some market where he can trade, that represents a profit opportunity and he is going to basically trade on that information accordingly. That means that information is going to be communicated through these markets in a very efficient and rapid way. These guys talk with one phone in one ear and a phone in another ear—or one phone in another ear and looking at their computer screen, and essentially are acting to ensure that these prices are interconnected. And so the idea that essentially stuff can happen over in one market and essentially that is not going to be reflected in prices in another I just think reflects a misunderstanding of the way these markets work.

Mr. GOODLATTE. Let me, if I might, Mr. Chairman, ask Mr. Vice if he believes or he knows of evidence to support or refute Mr. Greenberger's contention that what is not being seen on NYMEX is heavy trading of shorts on the OTC.

Mr. VICE. I am not sure I followed all of Professor Greenberger's remarks. But in trying to take a couple of takeaways: no one has really differentiated yet in this conversation that there is an electronic OTC market, of which ICE offers, and there is a much larger non-electronic OTC market which are through voice brokers or through direct negotiation, as Greg just described. We obviously don't have any information about the latter. On the former, as I said in my testimony, there is no electronic OTC trading in U.S. crude oil or any other U.S. refined product today on ICE or anywhere else. So there is no data there to go get because there is no trading.

As I understand it, Professor Greenberger is suggesting that directly negotiated trades of the type that Greg described earlier between airlines and Goldman Sachs, and any other swaps dealer, should somehow all be moved onto a regulated exchange. And I think Greg did a good job of describing these are customized, privately negotiated deals that have sometimes very unique terms to fit the risk management need of that particular airline for a particular time frame or particular delivery point that may not match up 100 percent with the terms of a futures contract.

Mr. GOODLATTE. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The gentleman from Pennsylvania, Mr. Holden.

Mr. HOLDEN. Thank you, Mr. Chairman. We obviously have a difference of opinion on the panel how this Committee should move legislatively or move at all. And some of my questions have been answered already, but I am sure all of you are familiar with the panel we had yesterday of our colleagues, Mr. Stupak, Ms. DeLauro, Mr. Larson, Mr. Van Hollen, and their proposals that they have introduced into the Congress. I am just curious, what do you think would happen if one of those proposals, or parts of that proposal would be enacted into law in the marketplace? Would the money go someplace else so we would never have a chance to know what is going on in the marketplace? I am just curious as to your opinion if any of those, or parts of those, were enacted into law.

Mr. ZERZAN. Thank you, Congressman. It is virtually certain that proposals that would drive the derivatives business away from the over-the-counter markets or drive it off-exchange would not lower the price of energy. They would, however, relocate jobs and revenue overseas and they would remove the ability of producers to manage their price risks, which would mean ultimately that those price risks would be passed on to consumers. So it is fair to say that provisions which would harm the ability of the derivatives markets to allow people to manage risk will not result in lower prices.

Mr. HOLDEN. Mr. Greenberger.

Mr. GREENBERGER. First of all, the commercial users, if you talk to them, if you talk to the airlines, the truckers, the farmers, they can't use these markets anymore. They are so volatile that any price they are locking in means nothing to them. In fact, I just saw yesterday that the Chicago Mercantile Exchange has asked for an exemption from the bar of agricultural swaps in the statute to start selling agriculture swaps for soybeans. I forget the other agriculture thing. Soybeans stuck out in my mind because the farmers can't use the regular exchanges. They are so divorced from what the farmers believe are economic reality. I think they are walking into a trap there myself because the swaps market is only going to be more devoid of reality.

If you impose speculative limits is this statute going to continue to control speculation? The speculators will have to find other forms of investment to the extent that they are driven from these markets. And a lot of people believe, for example, the pension funds who are pouring money into Goldman Sachs, to buy long in these products they will then have to go back to conventional investments like the stock market. Don't forget these are bets, these are bets on the direction of where prices are going to go. It is like going to Las Vegas and betting on who is going to win a football game. It has nothing to do with building the economy. If you invest in stocks, you are growing a company, if you loan money to a company on a debt market, you are helping them grow. When the pension fund puts this in and, god bless them, they feel this is the way they are going to make money, they are betting. They are not buying the commodity. They are only betting on the price of the commodity.

And I find it interesting that in the Commodity Futures Modernization Act state gambling laws were preempted. They had to

be preempted because these swaps are giving the swap dealer money and in return he is swapping either the upward price or the downward price of a commodity, crude oil, soybeans. It is essentially a gamble. You are gambling on the price. There is so much of that happening, $260 billion have gone into the crude oil markets since 2004, that it is self-evidently putting wind at the back of those who want to drive the prices up.

Now, somebody made the analysis, "Gee, inventories went down, of course, that means prices are going to go up." People are forgetting that 3 weeks ago the Saudis said we will produce, produce, produce. That has been forgotten, the next day oil went up. Oil is not responding to supplies and Dr. Pirrong says, "Gee, this isn't hoarding. There are no inventories there." Of course, I am not saying it is hoarding, but one of the reasons there may not be inventories is because nobody is producing because why produce now if the price is going to go higher later on? And in fact that has been the thesis that OPEC has traditionally given for why they are not going to produce more, that they are only selling at a price that is not the direction of where the market is going to go.

Now, it is true the Saudis surprised everybody 3 weeks ago and said, "We will produce anything you want." I mean, they had limits. It was a shocking announcement. The next day, that was a Sunday, I believe, the price of oil went up. What really is happening there is OPEC, who is under tremendous pressure to produce, wants to make a point. We can promise you all the oil you want, but that is not going to undercut the price. The price has become detached from supply/demand fundamentals. Why is it detached? Because if you take the swaps dealer funds, people are pouring money into those funds long. And then Goldman Sachs, which is going short to deal with that long, has to go out into the market and buy long to cover its short bets. And that is distorting this market.

Mr. HOLDEN. Thank you.

The CHAIRMAN. We will let him respond.

Dr. PIRRONG. Thank you. A couple of things. First of all, in terms of specific proposals, the proposals to dramatically increase margins on futures would tend to drive activity off the futures exchanges towards over-the-counter markets where people can negotiate their own collateral. And I think that would be highly disadvantageous in terms of if you want to promote price transparency and transparency in the market, that that would have a very pernicious effect.

In terms of the participation of financial institutions in the market, it just sort of points out the sort of yin and yang nature of these markets. For one set of people to want to get rid of risk, you have to have another set of people that want to take on risk. And making it analogous to gambling or Las Vegas or what have you, that is very entertaining, but, essentially that is a vital role of the market. And if you want somebody to hedge, there has to be somebody taking on that risk. And frequently it is going to be a financial institution or a pension fund or somebody that most effectively can do that.

The CHAIRMAN. Thank you. The gentleman from Kansas, Mr. Moran.

Mr. MORAN. Mr. Chairman, thank you very much. I appreciate the opportunity to further explore these issues. Professor Pirrong, you in your testimony, which I have read, it seems to me that words matter and you make an attempt to outline various phrases and words. It seems to me as I read your testimony that words matter to you. And one of the things that has troubled me in the debate that we have had is that the words "excessive speculation" seem to be interchangeable with market manipulation. And I think your testimony, although I give you the opportunity to confirm my understanding, points out there is a significant difference. One is illegal and disadvantageous to the economy. I am not sure whether "excessive speculation," whether that phrase has existed in either economic or legal terms in the past. Do we study excessive speculation in the schools of economics, are they written in the rules and regulations of the CFTC or the laws?

Dr. PIRRONG. Well, I think the phrase "excessive speculation" is in the Commodity Exchange Act but certainly not a concept that has a lot of traction in economics. We understand what "speculation" is. We understand what it means but drawing the line as to what is "excessive" and what is not is very difficult.

What I would go back to is something I raised in my initial remarks, which is to the extent that there is some distortion, whatever label you want to put on it, there is some distortion that is taking place as a result of activities in the derivatives markets that would leave a very clear trail in other data, in particular quantity data in terms of whether it be production or inventory and things of that nature, and we just don't see that.

Mr. MORAN. In that regard, tell me the bad consequence from speculation as compared to what I would call market manipulation. To me, to have something bad, economically, occur and someone take advantage of the circumstance, it would require hoarding or hoarding mentality or collusion. How do you get an increase in price just by the activity of speculating between two individuals or two entities as to what the price is going to be in the future?

Dr. PIRRONG. Well, a couple of responses to that. First of all, you are right, in terms of manipulation that results from the exercise in market power. And that typically results from one dominant trader or a group of dominant traders colluding with one another to do something to distort the market. On the other hand, if you have speculative activity, some people are speculating on information. They have information, folks that are speculating in the market, they do a lot of research to try to figure out things about supply and demand to the extent that their orders are informative, that will affect prices, but it will have the tendency to drive prices to where they should be. That is reflecting all the relevant information that is abroad in the marketplace.

Mr. MORAN. What is the value of speculation to the American consumer? How do the futures market and off markets speculation provide benefits to the American economy?

Dr. PIRRONG. There are a variety of benefits. Most importantly, it facilitates the efficient allocation of risk. So it allows the transfer of risk from those that bear it at a high cost, which may be, for example, a highly leveraged airline, to those that can bear it a lower cost, which might be a pension fund that sees an advantage

in being able to diversify and giving its investors a better risk-return tradeoff. Also these markets in speculation facilitate the discovery of prices. People go out, they commit resources to investigating, doing research on supply and demand fundamentals, take that information into account in their trading, that affects prices and assures prices reflect those fundamental factors and leads people to allocate resources efficiently.

Mr. MORAN. In earlier hearings, I was interested in the topic of convergence. I walked in late for the testimony and I am not certain that anybody has used that word in the testimony today. But is there something that we should be looking at as we look to see how the prices converge at the end of the futures contract with the actual market price that would give us a clear understanding that the markets are transparent and efficient?

Dr. PIRRONG. What I would say is absence of convergence can sometimes indicate a manipulative distortion. So, for example, when somebody is manipulating the market, executing a corner or squeeze for example, that is going to cause the futures price and the price of the deliverable to diverge from its normal relationships. And that can be sort of a warning light that the market is not working properly.

Mr. MORAN. And is there evidence today in regard to convergence in regard to the oil markets?

Dr. PIRRONG. No, sir.

Mr. MORAN. In other words, there is no divergence?

Dr. PIRRONG. Yes, sir.

Mr. MORAN. In the markets today?

Dr. PIRRONG. Yes, sir.

Mr. MORAN. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Would you yield me——

Mr. MORAN. I have no time, but of course I would yield to the Chairman.

The CHAIRMAN. The discussion you just had assumes that there is a free market and OPEC is not allowing this to be a free market, is it? I mean, there is this question that we had before about the supply of stocks. Well, they can store that stuff in the ground as well as they can in a tank someplace and you have this cartel that can control this thing basically and how does that all fit into this? I mean, I am no expert on all this oil stuff, but——

Dr. PIRRONG. I think we can draw a very important distinction here. Certainly OPEC might be able to take actions that can cause the prices to be higher than they would otherwise be. For example, extracting oil at an insufficiently rapid pace to constrain supply. But that is fundamentally different from speculation. If speculators were distorting price—if they say, "Hey, we are willing to pay this high price and we are willing to get our Guccis dirty with gooey oil to do it," they would be the ones that would end up holding the oil. So what you would expect to observe is that with speculators driving the prices, they would end up causing them to be higher than they should be. They are the ones that should be owning the supplies of physical oil. Conversely if it is OPEC doing something, that could very well have an impact, but it is not going to manifest itself in the same way.

Mr. MORAN. Reclaiming the time I don't have, Mr. Chairman, maybe the point of that is what Mr. Greenberger said about not finding hoarding, that hoarding could be in the ground, that makes sense to me. Maybe the point of this is that the culprit may not be speculation, but the culprit is the cartel that is withholding the supply. We are not having a hearing on the cartel, we aren't having a hearing on OPEC and we aren't having a hearing on that topic. But, is it not a greater factor in determining the price of oil, OPEC, than it is the fact that people are speculating in the future prices of petroleum?

Mr. GREENBERGER. I would just say this: As Dr. Pirrong has said, and by the way I am not a doctor, I am a Juris Doctor, but I can't call myself a doctor. The Act bars excessive speculation for better or for worse and maybe if speculation is good, that should be struck from the statute. I think that is what you have to say to yourself. That was a fundamental premise that was made. The farmers were getting burned in the 1930s by speculators. I think the airlines will tell you today they are getting burnt by speculators. Maybe they don't know what they are talking about. But if speculation is great, let us get excessive speculation out of the statute. The way excessive speculation finds its way into the regulated markets is speculators have limits on how much they can participate.

So all I would say is if speculators are wonderful, then I think we have to be candid and tell the truckers, the airlines, the farmers to get the automobile manufacturers, you are wrong, this speculation is terrific and the Commodity Exchange Act is not going to deal with speculation.

Just to flip that around, these markets were designed for businesses to hedge their business concerns. Yes, you needed speculation to make these markets liquid, but the statute says no to excessive speculation. It is absolutely true that you can have problems here with no manipulation at all. But you have to answer the question, if speculation is good and healthy, then let us get rid of the excessive speculation bar in the statue. If it is not good and healthy, then you have to go out into these markets which are unregulated and we don't know anything about and we can't find the information and say we have to control your speculation because you are adversely impacting the price.

And the Commodity Futures Trading Commission on its website, it talks about the economic fundamentals of futures markets, futures markets are price discovery mechanisms. You go to the paper to see what crude oil is selling at and that determines what crude oil is. The Chairman is correct, a lot of this market is not being reported, but I think that is a distortion in and of itself, that if it was fully reported people would be seeing there is a lot more selling of oil than buying of oil and that would affect the price. You essentially are sitting here and I am sitting here making guesses about what is going on in the markets that are dark.

And by the way, before the Enron loophole was passed in December 21, 2000, every energy futures contract had to be on a regulated exchange.

The CHAIRMAN. Mr. Greenberger, that is not true. You didn't have to be. The problem was you didn't have legal certainty was the only issue. You could still do it.

Mr. GREENBERGER. Mr. Chairman, when you say that is not true, I really feel I have to answer that question.

The CHAIRMAN. It was happening before.

Mr. GREENBERGER. Can I answer your assertion since you have made it?

The CHAIRMAN. Go ahead.

Mr. GREENBERGER. The assertion of it was happening before because there was an energy swaps exemption.

The CHAIRMAN. But that is going to be there even with these bills that have been introduced.

Mr. GREENBERGER. I understand that. And if I could answer, I would like to be able to answer that question. The energy swaps exemption was for individually negotiated contracts. You could not have one economic term negotiated in advance. Now, if this purpose is to have standardized contracts that can be liquid. Now, maybe there was trading. Yes, I will tell you, Enron opened Enron On-Line before they got the Enron loophole, but that was not legal trading. And I would be happy to carry this dialogue on further, but I stand by my proposition that energy futures contracts, just like agricultural contracts today, cannot be traded, could not be traded off-exchange. That is why Enron wanted the Enron loophole. Agricultural products today cannot be traded off-exchange. That is why the CME is asking for an exemption to have agricultural swaps.

And I would finally say the Goldman Sachs index does trade, part of it is swaps in agricultural products. I think that is flatly in violation of the statute. And I think that will be later shown to be.

The CHAIRMAN. We will investigate that. And what I wanted to say earlier is that you need to understand what the political situation was in 1935. Farmers were desperate. They were looking for somebody to blame, whoever. And so I can easily see why they would put excess speculation in there, just like I have some letters from my fuel dealers and so forth, from the airlines who want to have an answer for their Board of Directors because the CEO is under fire. You know, we just need to understand all of that. What I am trying to get to is, show me the facts here that will tie this thing together. And I still haven't seen that.

Mr. Zerzan, you wanted to say something and then we are going to get to Mr. Etheridge. I apologize.

Mr. ZERZAN. Thank you, Mr. Chairman. I would just point out that the purpose of ISDA is not to create standardized liquid documents. It was to create a framework of documentation, the material economic terms of which any individual trade would be negotiated between the parties. But ISDA is not in the business of creating futures contracts. We are in the business of helping facilitate the individual negotiation of bilateral contracts.

The CHAIRMAN. The gentleman from North Carolina, Mr. Etheridge.

Mr. ETHERIDGE. Thank you, Mr. Chairman. Let me thank each of the witnesses here today. I am sitting here trying to think how

to start. And I thought what I might do after all we have heard is that we really are about setting a framework that is fair to the consumer and fair to the producer, really and truly. That is what it is about. Now, a lot of people in the middle get in the game.

But on Sunday night, I got a call from a friend of mine who is a lawyer. He employs nine employees. In March of 2007, he was paying about $5,500 a week for fuel for five trucks and all of his skidders in the woods. A year later, he shut down his operation, laid all those people off and took a 3 month sabbatical without pay because when he had paid his fuel bill he had no money left. Now, you may say that is his problem, he didn't hedge. The truth is, we are trying to get a handle on this because it is really about those folks. The folks in between who handle paper and do all the other stuff, they are going to be all right. Now, he is back in business, he sold off part of his equipment and ultimately at the end of the day, his banker helped him heal the situation, the warehouser gave him a little more allocation of fuel money if he would keep a list of what he put on his skidder and what he put in the truck.

So we need to sort of keep a framework of where we are as we deal with this because the public doesn't understand futures, swaps or derivatives or anything else. But our job is to try to get a framework that is fair and protects the American people. That is really where we are and I hope we will keep that focus. I could share a lot of other stories. But my question, Mr. Comstock, is to you.

Given that APGA, as your testimony says, values the different needs served by the more tailored OTC market, does your organization or would you support legislation, of which this Committee is going to be looking at, as soon as we finish all the testimony, that it would eliminate the OTC market with respect to energy commodities as some of these claim to do, or just share with us your thinking on that. I think it is important for us to have that as we try to get a handle on these things.

Mr. COMSTOCK. Mr. Etheridge, thank you for the opportunity to comment. I don't believe that APGA supports the elimination of OTC markets. But APGA does support the position that data and information are important.

Mr. ETHERIDGE. Transparency?

Mr. COMSTOCK. Transparency, yes, sir, in a word, it is important.

Mr. ETHERIDGE. Those are two different things is the reason I asked the question that way.

Mr. COMSTOCK. The transparency is important to us to provide information to know what is happening in those markets. That is our position and that is what we would support.

Mr. ETHERIDGE. Okay. Thank you. My colleague, from Kansas raised the issue of OPEC. I wish you could be talking about that today because when this issue came up in the 1970s, we were importing far less oil than we are today. And they do set the threshold of how much they will produce. The truth is when they said they were going to increase the production here recently, all they did was reduce production in another field. So it was sort of a net-net.

Dr. Pirrong, we have heard comments that there is too much liquidity in certain commodity markets and I think I have an awful lot of constituents who really believe that. What are your thoughts

on this statement? Can there be such a thing as too much liquidity? And if so, what does that look like? How does that affect the market and how do we put in place mechanisms to make sure there is adequate liquidity to make the market work? As someone on a farm would say, "Enough grease to grease the machinery and make it work and not too much grease to get it all over the axle and mess up everything else." I think that is what we are about right here. We talk about it in a lot of terms. But the real issue is having enough liquidity to make the market work and not too much to mess up everything.

Dr. PIRRONG. Yes, sir. Well, I think there is a market for liquidity like there is a market for other things. And essentially that market will typically work in a way that ensures that the right amount of liquidity is there. Where does liquidity come from? Liquidity comes from capital. To the extent that people are demanding liquidity, the price of liquidity is going to be high and that is going to attract capital there. Conversely, to the extent that people don't demand liquidity, hedgers aren't in the market, they don't really need the liquidity, there will be a low demand and there would be relatively less capital.

Mr. ETHERIDGE. I understand that. I understand that theoretic statement. My question is a little deeper than that. You have to make sure if there aren't any regulatory schemes. I think my question is, how much liquidity does it take, otherwise every dollar will chase certain things. You and I know that. My question is, how do you devise that framework so that you have adequate liquidity to make it work and not too much to over-stimulate so that others suffer? Does that not necessitate putting in some kind of framework that limits the lubrication, so to speak, to adequate and not excess?

Dr. PIRRONG. First of all, I think we should be somewhat clear about the use of liquidity, because it is frequently used in different ways. For example, the central bank, the Federal Reserve provides liquidity to the economy, and it is arguable that over the last years that the Fed has been too liberal with that and the Feds actually contributed to problems in the economy, for example, the weakness in the dollar and so on.

Mr. ETHERIDGE. It lost about 43 percent.

Dr. PIRRONG. And that is sort of a different issue than talking about liquidity when you are talking about a market. And liquidity basically means how expensive is it to trade? If I want to buy, am I really going to jack the price up? If I am going to sell, am I really going to drive the price down? In terms of a framework, I think we can rely on the market to provide the right amount of liquidity. And what we need is a framework that basically ensures that people do not do economically inefficient things, most notably that they don't manipulate the market by exercising market power. I think if you have that sort of framework in place, that the market will serve to allocate capital to provide the right amount of liquidity, not too much, not too little, be just like Goldie Locks and get it just right.

Mr. ETHERIDGE. You are saying but without total transparency, it is kind of hard to know that is happening?

Dr. PIRRONG. Well, not necessarily. If what you mean by total transparency, but in a sense that you can have a market that is liquid and you can be confident that the market is liquid, even if the regulator can't observe every nook and cranny and position of what is going on in the marketplace. So usually more transparency is better, but I wouldn't believe that essentially having complete transparency would lead to that much of a better operation in the market, and particularly I don't think it would lead to better liquidity. In fact, having too much transparency, and this goes back to a point that was raised earlier by Mr. Zerzan, actually impairs liquidity and make markets less liquid because again concerns about front running and so on.

Mr. ETHERIDGE. Thank you, Mr. Chairman. I always happen to believe a little sunshine helps a lot of things. It has a way of purifying a lot things. Thank you, and I yield back.

The CHAIRMAN. The gentleman from Louisiana, Mr. Boustany.

Mr. BOUSTANY. Thank you, Mr. Chairman. I still believe that the fundamental problem is a lack of supply and very tight supply and demand coupled with a weak dollar and the absence of a comprehensive energy policy for this country. I want to thank my colleague from Kansas for pointing out the distinction between excessive speculation and market manipulation because market manipulation is really the culprit that we are concerned about.

Another point I want to make is that in looking at the Commodity Exchange Act, there is no definition of "excessive speculation." So I would ask Mr. Greenberger, does he have a definition?

Mr. GREENBERGER. The definition of "excessive speculation" in the Commodity Exchange Act, if you go to any farmer who trades on an exchange, he will tell you that the way it is defined is that every contract there is a speculation limit. So that the exchange works out with the traders, how much speculation do we need in this market to make the market liquid. And in the ag market, they are hard and fast spec limits. But even in the crude oil markets on Dr. Newsome's exchange, NYMEX, there are accountability levels, position limits. They have never defined it because it is like defining some algorithm on a contract-by-contract basis. The way it is worked out in the real world is the exchange, if it is regulated, has a process where they limit the amount of speculation through a speculation limit. It is different. There are thousands of these contracts and there is a limit on every different contract.

Mr. BOUSTANY. It seems to me that those limits are set to prevent default.

Mr. GREENBERGER. Well, I read to you from the Commodity Exchange Act report in 1936.

Mr. BOUSTANY. I have the definition here with regard to "excessive speculation" and "limits on trading," and there is no definition of "excessive speculation." It just simply says, "Excessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets or derivatives transaction execution facilities causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity is an undue and unnecessary burden on interstate commerce on some commodity." So it just lays out the need for regulation, but it doesn't define it.

And I want to thank Dr. Pirrong for actually giving us something to work with here because he makes the distinction between the physical markets and the derivative markets and says there is an empirical metric that we can use and that is to look for distortions in inventories and supply. And I think that was a very useful statement that you made to help us in terms of trying to understand this and to set policy. I think this is a useful metric.

Earlier, Mr. Greenberger, you mentioned the Saudi announcement that they would produce 200,000 additional barrels of oil per day. And yet we did not see a drop. We saw perhaps a rise. And that would undermine your argument. We still have a major supply problem. And 200,000 additional barrels of oil a day is not going to take care of that. And I would suggest that if they were making that—if you saw a lot of market manipulation-type activities, we would have seen drops.

So again I think we really need to look at the inventories and supply, as Dr. Pirrong mentioned, because we can't get our hands around something that is tangible to understand what is going on. We really haven't had any discussion here today about the impact of the weak dollar. And just this week, the dollar showed strengthening against the Yen and the Euro and we saw a $5 drop in the price of crude oil. So I would ask each of you maybe to comment on that and the impact of the weak dollar on this problem. Mr. Zerzan.

Mr. ZERZAN. Thank you, Congressman. I think you have aptly stated the problem. The weak dollar has certainly contributed to the rise in the price of oil for the U.S. consumer.

Mr. BOUSTANY. Thank you. Anybody else want to comment on that? Again, I would say if you look at the weak dollar, coupled with the lack of a comprehensive energy policy and tight supply and demand, I think you have to go beyond just the actual physical commodity. We have a workforce shortage in the oil and gas industry. The other commodities, such as steel, rig materials and so forth, there are shortages there. I think these are all factors that come into that calculation of the paucity of supply that is creating this fundamental problem.

Mr. GREENBERGER. With regard to steel, you should know that I understand the steel industry is taking the position that there should be no steel futures contracts because it will distort the price of steel. And also with regard to the Saudis, I don't have the statistics in front of me. They may have said 200,000, but they had a program going all the way out for a couple of years and I think it was a lot more than that. And I must say everybody I knew and I myself was sure that the day after they made that announcement there would be a drop.

Mr. BOUSTANY. Mr. Vice, you were going to make a comment.

Mr. VICE. I was just going to add that if you look at the full price curve that the futures markets are telling you, it is not indicating a bubble, it is not indicating a short-term bottleneck in supplies. It is $135 or $140 out through 7 or 8 years. It is sustained. I am not an economist or expert, but in my view I agree completely with you. There are fundamental factors here that short term, medium term, long term, the marketplace is recognizing there has been a long, under-investment in supply and the infrastructure to refine

that supply and get it to market. And it is my belief that this is what that is reflecting.

Mr. BOUSTANY. We have seen a decline in almost all producing fields, whether you are talking about Venezuela, Nigeria, Mexico and on. So I appreciate your comment. Thank you. My time is up. I yield back.

Mr. HOLDEN [presiding.] The gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman. Dr. Pirrong, I think you can help us out a little bit. We have had a lot of testimony and it is not just yesterday and today, but previously, on the possible impact of pension, sovereign wealth, you name it, money moving into commodities and taking positions. Whether it is buying ETS, whether there is actually an underlying commodity that is being purchased and held, or whether it is an index fund or something like that. There are those who say that the market, talking about oil, would proceed apace, it would not be distorted by this phenomena at all. You wouldn't see the distortions that you are suggesting. You would have to see if there is some sort of market manipulation or something else going on here, other than sort of normal day-to-day process. But what would happen, some say, is that the overall price goes up because so much money is in there that is long. If the mechanism chosen to give a position in oil is in essence a long position in the futures market, whether it is OTC or it is the regulated markets, the effect of that is to pull—since there is not as much money on the short side to start out. With all this money coming in long because that is the investment ploy that the money managers think is wise under their circumstances, taking into account all things, including their expectations concerning the future where commodities are concerned with a globe that is becoming more and more populated. The folks who are on the short side see this phenomena and they are going to move up also. And the price generally will move up as a result of that phenomenon.

Could you comment on that?

Dr. PIRRONG. Yes. First of all, I want to draw this distinction between the physical and the financial markets. Even on a commodity like oil, there is a financial oil market and there is a physical oil market. The concern expressed earlier about the gentleman having to pay so much for his gas, his fuel bill that he couldn't operate his business anymore, that is really what is going on in the physical market. And if you look at the connection between the physical and the financial side of the business, most of the money, virtually all of the money that is going in the financial side of the business; they are price takers, they are not price makers. So, for instance, the indexes, which we have heard a lot about, they rule their positions as their contracts move towards maturity. They are sellers, not buyers. Even if they are originally long and they are going to sell their futures positions as they——

Mr. MARSHALL. If I could interrupt. What we have been told by some is that the strategy is one that ignores price and says, "We are going to be long indefinitely. We are passively long. And the idea here is our strategy will be to roll every 3 months or 5 months and whatever the price is, we are just going to stay on the long side." And it is a lot of money doing that. That is what we have

been told. And what I have a hard time seeing is what impact, if any, that kind of strategy might have on our markets. It is the only thing at this point that seems really anomalous, and it is something that has occurred in the last year or two and it has really increased dramatically. At the same time we have seen these price increases that we don't understand increase phenomenally. And, frankly, when you talk to OPEC and Big Oil, they can't figure out why the price is going so high.

Dr. PIRRONG. First of all, OPEC sometimes has an incentive to try to point the finger at somebody else. What is more, I still think it is very important. If speculators, or index funds, or passive long funds, if they were the ones that are keeping the price high because they say, "Hey, we are not price sensitive, we are willing to outbid anybody else." If they are having an impact on the physical market, they would have to be the ones outbidding everybody else in the physical market and they would have to be the ones that were holding the oil. That still comes down to the key issue here. And again if you just look at the mechanics, when oil becomes prompt or when a corn contract moves towards expiration, this passive money is selling the nearby, they might be rolling in and buying the deferred, but their demand is not translating to the physical market, which is essentially what determines the price that we are going to pay at the pump or the grocery store.

Mr. MARSHALL. The participants in this market are quite sophisticated and we are told there is just about virtually nobody who didn't look to see what is going on in the futures market in part as a means to determine what sort of price should be offered on the spot market. And there wouldn't be any distortions in the actual process, in the physical market, if the participants generally were doing that sort of thing. And we are told that they are doing that sort of thing. Do you discount that possibility?

Dr. PIRRONG. I don't think that these statements are necessarily inconsistent. But at the end of a day as a contract moves towards delivery, and that is what I essentially was referring to when I was talking about my experience in designing delivery mechanisms, when a contract moves towards delivery, people have to say, "Hey, here is the price of the expiring futures, do I want that oil or not, do I want to be a buyer or a seller." That oil price, that futures price is going to accurately reflect the fundamentals in the marketplace. So given that people are confident that with a well operating unmanipulated delivery process that the price in the futures market as a contract moves towards expiration reflects fundamentals, they are going to be more than willing to base their pricing decisions on what they see going on in the futures market.

So I would actually say that that argues for essentially the market's confidence that the futures prices are accurately reflecting physical market fundamentals as opposed to a situation where they believe that it is not reflecting physical market fundamentals.

I will give you an example. Back in 1989, there was a manipulation of the soybean market. People were wildly concerned in May and July that the soybean futures price was no longer representative of fundamental cash market conditions. So what did major grain dealers like Cargill and others do, they said, "Hey we are not going to make our pricing decisions on the basis of the May and

July contracts anymore because we believe that those are manipulated, that those do not reflect fundamentals." The fact that market participants indeed still rely on these futures markets to base their prices indicates the high degree of confidence in the accuracy of these markets in reflecting fundamentals.

Mr. VICE. Congressman, if I could add one point. I think too, a lot of what I will call dumb, long, only passive investment money coming into these markets, that is the kind of situation that active traders look forward to, quite frankly, because they are not trading in a dumb manner. They are studying the fundamentals, short-term, long-term fundamentals, and to have a counterparty on the other side of a trade who is not doing that is a big advantage for them. So typically what you will often see in the history of any prices as it moves around and you have any kind of phenomenon that is causing that type of investing, that is a profit opportunity for people that are studying the fundamentals. I think what you are seeing is those active, informed traders are looking at the fundamentals and they are not seeing fundamentals that argue for lower prices and they are not coming in in the same high volume. This is my own opinion. I am not basing this off numbers I have seen. But in the same manner they might if they thought this was actually that this dumb money did just happen to be right in this situation.

Mr. MARSHALL. Thank you, Mr. Chairman.

The CHAIRMAN [presiding.] Thank you, Mr. Marshall.

Mr. Conaway, I guess you are the last standing over on that side.

Mr. CONAWAY. Thank you, Mr. Chairman. I appreciate our panel being here today. I am no OPEC apologist. I grew up in west Texas and I was trying to make a living when the price of crude oil fell from whatever it was to $8 for sour crude and $12 for sweet crude in 1999, 8 years ago. But as we continue to bash OPEC, that bashing seems to be based on a premise that we have some right to their oil, that we have some mechanism that we can demand them to sell us stuff that is their property. And at the same time, I would argue that the U.S. is probably the single largest hoarder of crude oil and natural gas by the fact that we have restricted access to our own supply. We refuse to produce our own supply of crude oil and natural gas. And the net hoarding on behalf of the United States is contributing to the folks that Mr. Vice talks about who look at the actual things that are going on.

Just a quick question. Does everybody make money in the oil stuff?

Mr. ZERZAN. No, Congressman. For every long, there has to be a short.

Mr. CONAWAY. So folks are losing money in your world as they take these risks or try to lay these risks off?

Mr. VICE. Trading is a zero sum game.

Mr. CONAWAY. There you go. And also some great history lessons for Mr. Greenberger about the 1930s and the 1940s. I suspect today's information that is available limits the kinds of things that were going on with the locals that they were doing in Chicago and it was a closed loop and those guys were just hanging out in a small group. So I think today is fundamentally a different day.

Mr. GREENBERGER. Mr. Conaway, could I respond to that, please?

Mr. CONAWAY. I would like the record to reflect, Mr. Greenberger, that you have spoken more today than any other single person here.

Mr. GREENBERGER. I would disagree with that, but if——

Mr. CONAWAY. Thank you. It does not surprise me that you disagree with it. I have a limited amount of time.

Mr. GREENBERGER. You referenced me and I would like to be able to——

Mr. CONAWAY. You got your word in. Again, you have spoken more today—you might ought to run for the Senate. I don't think speculators are doing what is going on. I think there is a supply issue and a demand issue. Because my producers will sell every barrel they have at $140 a barrel. There is a refinery out there that has got to buy that at $140, convert that into product that he or she can sell across a wide spectrum of uses and try to make money at that. If that can no longer be done, then those refiners are going to quit buying oil at $140 and somehow the physical market is going to drop, I would suspect. How do I answer the folks who say it as if it is a self-evident statement that speculators are causing this problem? In fact, if you look at the supply issues over the last 15 months *versus* demand issues, yes, demand is coming up and supply is just holding its own. But, there is not a dramatic reduction in supply that would double the price of crude oil.

And one other comment I made. The Saudis say they are going to increase production by 200,000 barrels a day. There is 86 million barrels produced every day. And I am not real good at math. I am a CPA, but I am relatively good at math. That is not much of an interest against 86 million. How do we answer the folks who say, "Supply and demand, yes, there is a tension there but it is not a lot different than it was in January of 2007 when the price was much less than it is right now."

Anybody.

Mr. VICE. I would say clearly the demand is very inelastic there. We also, for example, host electric power markets in our marketplaces. And given that power can't be stored and given that everyone also feels they have a right to light and heat and that demand is very inelastic, so you can see very small imbalances in supply and demand, which actually you can't even have in the power market. But to the extent you are at the maximum capacity of what the system can provide, you can see dramatic price changes there. I think that is probably the most extreme example because it can't be stored.

Mr. CONAWAY. What about crude oil?

Mr. VICE. Same thing. Again, there are not a lot of alternatives. If you have to drive to your workplace, that is what you have to do. You don't have a lot of choices right now in terms of alternative technology, alternative transportation, and it is going to take some time before these price signals are perceived as being semi-permanent and there is real behavior change in terms of demand.

Mr. CONAWAY. Thank you, Mr. Chairman. I yield back.

Mr. VICE. It is not an answer anyone wants to hear.

Mr. CONAWAY. Let the record reflect I yielded back on time, please.

The CHAIRMAN. We appreciate it, Mr. Conaway. The gentlelady from Kansas.

Mrs. BOYDA. Thank you very much, Mr. Chairman. And I have so many questions. If we could go real fast. I really am trying to figure out which this is on. So, clearly we need to increase supply. I don't think anybody disagrees with that, the supply of oil, the supply of alternate fuel, supply, and supply in general. So let me state that as a given.

But it is interesting, why, do you think, when we were just talking with Mr. Conaway, 100,000 barrels when Nigeria is having trouble. What happened that day? And yet, 100,000 barrels the other way, 100,000 barrels is 100,000 barrels. We did the SPRO. So clearly there is some psychological stuff that is going on. It may not actually be manipulation. Let me just state that.

In January of 2008, $450 million a week was going into the oil speculation, and in March of 2008, $3.4 billion was going in a week. I got a briefing from CRS last week. I am trying to get this all figured out. What did we see happen when that much speculation went into the market in that short amount of time? Does anybody know? Basically we saw a tenfold increase in the amount of dollars going into the market. Do we have an idea of what happened with the price in that period? If somebody could get it for me for the record, I would appreciate it.

Mr. GREENBERGER. I can say the price has gone up very, very substantially. I will supply something for the record, but my memory is that in the last year, the price has gone up, something like 100 percent.

Ms. BOYDA. In 3 months, according to CRS data, we saw tenfold, nine-fold, let's round up to tenfold increase in dollars just going into that marketplace. And if anybody would like to just give me what you think are those, what you think it is if it should have gone up more, if it was speculation, if it did go up or whatever I would appreciate knowing that. If this is manipulation, and excess speculation, whatever words that we want to use, and I understand those are hard. If it were not market driven, does that mean there is a bubble, and if so, when would we expect to see it burst? I mean, how much longer does this go on.

Mr. GREENBERGER. Many people, Congresswoman, have said that it is a bubble. This is, of course, the debate. And that the bubble will burst. Many people say the bubble will burst when people like Mr. Etheridge's trucking company finally doesn't get another loan from the bank and Weyerhauser doesn't extend more credit. And these companies will, as you are going to hear from the airline companies, they will go down. Boeing will go down with them because they won't be buying planes. There will be a serious economic dysfunction and the bubble will burst. And the question I pose is, do you want to wait for that to snap? Or do you want to go back to the way we had done before?

Ms. BOYDA. So in your estimation, if this is speculation, you think it could go on, there won't be anything that will show it for speculation until we see some kind of real correction in the entire economy.

Mr. GREENBERGER. I hope I am wrong about that. And I only know what I read. But a lot of people, I am not saying everyone,

says that it will, this bubble will only burst when we go through a very serious recession.

Ms. BOYDA. Okay. Thank you. Mr. Comstock, would you just summarize for me what do you think we ought to do? Just, I know we need to increase supply. We all agree on that. What else do we ought to do? Should we do?

Mr. COMSTOCK. Boy, that is a——

Ms. BOYDA. And you have 1 minute and 21 seconds. Actually, I would rather that you not even use all of that.

Mr. COMSTOCK. I appreciate that. I think APGA'sposition is an increase in transparency. We need to see what is going on.

Ms. BOYDA. What does that mean specifically?

Mr. COMSTOCK. To understand what is going on in the markets, to see how the trades fluctuate, where the information is. I think the Chairman hit it early on in his statement, to find what is happening out there. And I am not sure we have that information.

Ms. BOYDA. So when Mr. Greenberger is talking about, the longs are transparent but shorts aren't, do you agree with that statement?

Mr. COMSTOCK. No, not necessarily, I do not. I am not sure that we have——

Ms. BOYDA. What would you like to make transparent?

Mr. COMSTOCK. The overall market itself. I am not sure that we have enough information in front of us to understand exactly how the overall process happens. And that is what we are looking at. I am not sure what total transparency means. I heard that earlier. We don't have a good definition of what total transparency means. When we get that maybe we will know what we have in terms of that definition, but at this point, I am not sure we have moved far enough in the idea of understanding what is going on to know that we are transparent enough to understand the process and the market.

Ms. BOYDA. I think we all agree, transparency is good. Supply is good. I am just trying to get my hands around what transparency, what specifically, what transparency we are looking for. I do believe that we can do harm when we try to insert ourselves too much into this market. So this is very difficult, and I appreciate each one of your being here today.

The CHAIRMAN. I thank the gentlelady. The gentleman from Michigan, do you have questions?

Mr. WALBERG. Thank you, Mr. Chairman. I apologize for being late, but I was interested in hearing some of the responses thus far. And I just, in fact, in a meeting I just came from, some information was provided to me that I think I would like to ask the panel to respond to. I think we all agree that supply is necessary. And when we have seen in the United States, consumption decrease, and yet the costs continue to rise, of course, that says to us that if we are unwilling to compete, unwilling to produce, unwilling to increase our supply, that has impact.

But the issue of subsidies, and I don't know if that has been brought up yet today. But I would like some comment or response on it when I see, according to this report here, that total demand in subsidized regions of the world has increased from 28 million barrels per day, that is a 37 percent of global demand in 2000, to

an estimated 36 million barrels per day or 42 percent of global demand in 2008. It seems like when you have that type of subsidized energy, that that is going to have a direct impact on the United States if we are unwilling to compete by being unwilling to produce more and develop a greater supply. I look at a report here that says that China, for instance, well, let's go from the bottom up. India, whose demand continues to expand geometrically, is at a total subsidized demand growth of ten percent. Latin America is at 19 percent of total subsidized demand growth; the Middle East, 29 percent; and they are paying what, a $1.25 a gallon, 29 percent total subsidized demand growth. And China, at 36 percent, even though they have reduced a bit of their subsidy right now because they can't afford it, but nonetheless reduced, they are still at 36 percent of total subsidized demand growth. Again, with us, unwilling to increase supply, unwilling to compete, and we have countries we are competing with, who are subsidizing huge proportions right now, what does that say to us? Jump on in.

Dr. PIRRONG. If I might, sir, I think that is a very important issue and that is actually one that I have sort of been blogging about for the last year. And it also relates to the issue of Mr. Conaway's question, why do seemingly small price disruptions have such big price impacts? The consumers in those countries that you are speaking about, they don't see price signals. So when the world price goes up, their price doesn't go up, so they don't cut back on their consumption. What that means is that demand is going to be very insensitive in those countries to price changes, and that actually can exaggerate, and exacerbate volatility in the marketplace.

So that is a very important issue. Also, if you look at these countries, oil exports have been flat or declining in a lot of these countries because of just what you discussed, which is they are subsidizing their consumption. So we have this phenomena where the exporting countries are consuming more and more of their own oil and probably in a very wasteful way. So I think it is a very important feature in the market, and it is contributing to the high and volatile prices that we are seeing.

Mr. WALBERG. I see my time is up. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. The gentleman from Wisconsin.

Mr. KAGEN. Thank you, Mr. Chairman, for holding these hearings, which are critically necessary to better inform Congress in terms of which way to go. But let's not forget why we are here. This energy crisis that we are in today is something that was totally predictable. It was predictable since 1973. We are also here today because government has failed. Our government has failed to come up with a meaningful and successful national energy policy to make us an independent nation, once again, as we once were in days gone by. So we are here because the failure of government and it is the failure of leadership of the current Administration to put together an energy policy that is anything other than drill and burn and drill and burn.

So I thank you for being here today to testify. But I want to lay the predicate. Last week I had the honor of listening to the people I represent in northeast Wisconsin, which is largely a rural district. We live in our cars. A farm family, a mother of several children,

told me that one out of four of her paychecks goes directly to gas just to get to work off the farm.

A cook who has several jobs has a part time job just to get the money to pay for his gasoline to get to his full-time job. And a waitress who is getting paid $2.43 an hour plus whatever tips come in is telling me that she has a difficult time raising her children and paying for her gas bill at the same time as her food and her mortgage bill. This is a very real crisis and it is something that we have to take very seriously. And I am very interested in hearing your answers to just a few questions.

First of all, I have to comment, Dr. Pirrong, I strongly disagree with you. You are the only one I know that thinks we have an open and free oil marketplace when you have people in OPEC controlling supply and determining price. So I strongly disagree with you. But Mr. Zerzan, I have a question for you about whether or not you believe position limits for hedge funds, for swap dealers and institutional investors would be a good thing for the people I represent in northeast Wisconsin.

Mr. ZERZAN. Thank you, Congressman. Position limits are routinely imposed on traders. The provisions that are being proposed, however, in the law, currently, would remove the hedge exemption that swap dealers are currently able to avail themselves of. What that ultimately would mean would mean that the swap dealers counterparties, be they producers or be they commercial entities, wouldn't be able to obtain protection from swap dealers. They would be subject to the risk of rising prices and the inability to pass on that risk to swap dealers.

Mr. KAGEN. Let me just ask it differently. What would be the effect to Mike, who is a cook in Marinette and to some farm families I represent and people in Green Bay if limitations were applied to your industry on these people?

Mr. ZERZAN. Ultimately the effect of not being able to pass on risk to swap dealers means you pass on risk to consumers. So prices go up for the people that need to purchase these items instead of those risks being passed on to people who are better able to manage them.

Mr. KAGEN. In your view, what do you think the appropriate punishment should be for anyone who is caught cheating? Several days ago here in this room, one of the Commissioners of the CFTC said they caught 40 cheaters, law breakers, and they were fined $40 million overall in the last 5 years. What sort of jail time would you recommend for someone who violates the law?

Mr. ZERZAN. Well, Congressman, the market participants that ISDA represents are among the strongest believers that people that try to cheat or try to game the system need to be punished and need to be punished severely.

Mr. KAGEN. As far as you are aware, has anybody gone to jail for robbing and stealing us blind with these high oil prices?

Mr. ZERZAN. Well, Congressman, I am not sure I know how to answer that question.

Mr. KAGEN. It is sort of a yes or no. Are you aware of anybody that has gone to jail for violating these rules?

Mr. ZERZAN. I don't personally know anyone who has gone to jail, no.

Mr. KAGEN. All right. What do you think the effect would be of Mr. Larson's bill about limiting OTC transactions to those who are capable of taking possession?

Mr. ZERZAN. I think that would remove a substantial amount of the liquidity from the market and mean that people couldn't hedge their risk.

Mr. KAGEN. So you think that would punish the consumer?

Mr. ZERZAN. I think that would ultimately result in prices being passed on to consumers.

Mr. KAGEN. Would you agree with me that part of the problem that we have here is a speculative bubble simply because the ability of people to pay these impossible prices has been exceeded, at least in my district? And I had a meeting with people that distribute oil to over 1,500 gas stations. I have met with mass transit officials, school district operators, mayors and county executives. Everybody I am listening to says that we can't afford these high energy costs; they are busting our budgets. So wouldn't you agree there is a speculative bubble involved here?

Mr. ZERZAN. Well, Congressman, I would agree that prices are rising to levels that are hurting American consumers. But the separate question is whether or not limiting the ability to pass on these risks through derivatives would actually help or hurt consumers, and ultimately it would hurt consumers.

Mr. KAGEN. Interesting. Mr. Vice, do you have an opinion on that?

Mr. VICE. I guess I would generally add that, as someone said before, a market exists to transfer risk, particularly futures markets and largely the OTC market, not to procure a given commodity, but rather to people that want to get rid of price risk give it up to someone who wants to take on that price risk. I think speculators, whether they are swap dealers or other types of participants that are willing to that risk on are a critical and necessary part of a market. I would also add that, in general, the more liquidity the better. The more liquid a market is, the more broad the participation, the less likely it is for anyone to manipulate that market.

Mr. KAGEN. Well, Congress has already passed two pieces of legislation to try and attempt to do this. In fact, three of them. But in particular, the farm bill helped to close part of the Enron loophole, but it didn't do anything about the swaps. Do you think that swap loophole with regard to dealers and institutional investors has to be closed? Has to be addressed?

Mr. VICE. My view is that the——

Mr. KAGEN. Another way of saying it is, was the farm bill sufficient to mollify the marketplace?

Mr. VICE. Well, I don't know if it is going to mollify the marketplace. It starts with the premise that there is an answer in more regulation, and I don't think that is the case. But ignoring that, to the extent you want to, "close the Enron loophole," I think the farm bill does that in a very well structured manner. It recognizes that the OTC market is a very diverse marketplace in terms of some contracts that trade electronically and they have sort of a price discovery function, and they should be, or it is appropriate to regulate them like a future, which is what the farm bill does.

It also recognizes that there is a tail, a relatively small part of the OTC market that consists of hundreds, even thousands of different contracts that, in many cases, are traded by only a handful of participants in different parts of the world. They serve no price discovery function, and it would literally be impossible for ourselves or anyone else to apply exchange-like surveillance principles to such an illiquid market.

Mr. KAGEN. Mr. Chairman, if I could just ask another question. Mr. Etheridge has another bill, H.R. 6334, and this would seek to increase the ability of the CFTC to do its job. Do you have any opinions with regard to his bill?

Mr. VICE. We definitely support additional funding and additional staff for the CFTC. There is no question that is needed. And I would also say that we fully support transparency in any way, both in our OTC marketplaces and our regulated futures marketplaces around the world. We have shared data whenever asked or required to. We have not opposed and would support, to the extent more transparency is required of us as a marketplace, we are happy to provide that. And as someone said, "Sunshine never hurt anything."

Mr. KAGEN. And I would just finally ask all of you if you wouldn't agree that it would be a good idea for this Congress and this President to come up with a meaningful energy policy. In my view, much of the run up in the price here has to do with people betting against the house, betting against the ability of government to come up with a meaningful plan to begin to move us away from fossil fuels and away from being dependent upon foreign sources of energy. So if we did come up with this meaningful plan that drove us towards energy independence, wouldn't you agree that the price for OPEC's oil might go down?

Mr. ZERZAN. Certainly reducing the pressures on supply and developing an alternative source of supply would be a meaningful step.

Mr. KAGEN. And finally, wouldn't you agree that to whatever extent we could argue about the percentage, but the declining value, the declining purchasing power of the United States dollar applies to this situation? The oil hasn't changed in millions of years, but the dollar in your pocket certainly has. It doesn't buy as much oil as it did before. Some have estimated that 40 to 50 percent in the run up in the price of oil is due to the declining value of the dollar. Would you agree with that?

Mr. VICE. Yes.

The CHAIRMAN. I thank the gentleman very much. The gentleman from California.

Mr. CARDOZA. Thank you, Mr. Chairman. Mr. Zerzan, your written testimony questions a need and wisdom for greater disclosure of index traded traders and swaps dealers, mainly because of concern that the market functions better as I believe you said in anonymity. However, aren't traders on the regulated market, *i.e.,* the non-OTC markets, subjected to a higher level of scrutiny than your members currently are? In fact, the swaps dealers already have a front run on the market participants.

Mr. ZERZAN. Thank you, Congressman. The paragraph you refer to in my written statement regards proposals which would break

out the positions on regulating future exchanges of swap dealers and index traders. And the point of our concern is that anything which would allow someone to see the trading strategies of any individual market participant would put that market participant at a disadvantage, and would also provide opportunities for trading ahead or front running.

So the point of that concern is really that on-exchange trading, to the extent that their proposals to increase reporting of swap dealers or index traders, it should be very carefully crafted so as to not allow any individual firm to be disadvantaged.

Mr. CARDOZA. I have been to all the exchanges, and I have seen open outcry trading where everything is very transparent. You don't know exactly, but you have a good idea who is making bids and you can have an idea if someone is making plays. Everybody shares the same information at the same time in those kinds of markets. I support that. That is sort of a democratic way of doing the free market. What I don't like is when people behind the scenes have hidden advantages. And I think that is what we are sort of talking about. Later today, Dr. Newsome, in his testimony, supports the idea of restricting swaps dealers from obtaining hedge exemptions for position limits if they are conducting OTC transactions involving noncommercial participants. Would your organization support such a change?

Mr. ZERZAN. We would not support such a change. And I think that that would actually tend to impair liquidity in the markets and impair the ability of participants to transfer risk.

Mr. CARDOZA. Mr. Zerzan, this goes back to my earlier question. I believe there is a legitimate place in the market for swaps. And I am certainly not advocating restructuring the entire OTC market. However, it is really difficult for me to understand why your members can't bring themselves to this more transparent place in the market.

Mr. ZERZAN. Well the CFTC, in October 2007, addressed this point, and said, "Staff experience in surveillance of these markets does not suggest that the OTC bilateral or voice broker energy markets exhibits significant price discovery attributes." Thus, the direct impact on other parties and markets is limited.

Mr. CARDOZA. Mr. Zerzan, that was 2007. We didn't have $4 gas in 2007. Now CFTC is saying they need 100 people to regulate that market. You are talking about history when it wasn't happening.

Mr. ZERZAN. Well, Congressman, I think that prices were rising through 2007 and the point is——

Mr. CARDOZA. They weren't exploding like they are in 2008. I guarantee you that. You talk to my constituents and they are darn upset about what is happening in 2008.

Mr. Greenberger, I can't, as a University of Maryland graduate, go without letting you comment on the last thing very briefly because I have one more question I have to get to. Do you have an opinion on what you just heard?

Mr. GREENBERGER. Can you just refresh my recollection of what I just heard?

Mr. CARDOZA. Well, the question was, does the swaps market and the folks that Mr. Zerzan represents, do they get a hidden ad-

vantage by being able to go first or to be able to hide their maneuvers in the swaps market?

Mr. GREENBERGER. I think that the, there is a hidden advantage, but the most important hidden advantage is that nobody knows what is going on. That was not the way the Commodity Exchange Act was set up. Everybody is guessing what goes on on the bilateral or OTC market. Is it helping? Is it hurting? And the easiest way to answer that question is for transparency. Now, I am not saying transparency where competitors can see what they are doing. But as you pointed out, in the NYMEX or Chicago Board of Trade, large trader data reporting goes to the exchange every day. And that is not only useful to see whether there is excessive speculation. We are all here saying excessive speculation is different than manipulation, and I agree with that. And I believe we see excessive speculation. But we can't tell whether there is manipulation. I will tell you on the exchanges, the traders are watched by their surveillance systems, that they not engage in phony or fraudulent trading. We don't know what is going on. I am not saying it is happening. But we don't know. And all I am saying is let's find out. If everything is fine, terrific. But let's get the information we need.

Mr. CARDOZA. Mr. Vice, do you have an internal monitoring system to avoid skirting around your position limits or other requirements that you have on your exchange?

Mr. VICE. Let's clarify which market we are talking about. Well, let me ask you, are you referring to our over-the-counter market?

Mr. CARDOZA. What stops traders from registering under different names in your market? On all of the exchanges, or all the different products that you trade?

Mr. VICE. Well, okay. We have a U.S. exchange which is just ICE Futures, U.S. It doesn't trade energy. It trades agricultural products and financial products. It is regulated just like NYMEX, CME, has the same core principles it has to enforce. We also have an over-the-counter market, OTC energy over-the-counter market which is one of the requirements under that regime is it is a principals-only market and it has, and it is professionals only. It has high net worth, high asset requirements, so it is essentially investment banks, funds, companies like Mr. Comstock's or gas companies, power companies, utilities, oil companies, they can trade bilaterally, where they are taking each other's credit. You can do that electronically, just as you can do it through a voice broker. So clearly, they are establishing their credit with each other outside of the service we provide them. They can also trade that in a cleared manner where they give it up to a clearing house.

We enforce the requirements of that marketplace as the CFTC and the CFMA has required us to do. Requirements have been enhanced as time goes on, ultimately in the farm bill where we are in the process now of building these systems and the processes to do the large trader reporting, Commitment of Traders reports, position limit administration for contracts that are deemed significant price discovery contracts.

I hope that answers your question.

Mr. CARDOZA. Well, sort of, but I am going to ask it in a different way or follow up in a different path here.

Following up on your testimony, you said, basically ICE will fall under some new regulations that we imposed in the farm bill. And I believe in your testimony you said that some of these regulations will occur if and only if the CFTC decides an ICE contract serves significant price discovery function, and you will have a self regulatory requirement. However, a number of those requirements seem to be in common sense practices that should and could be implemented now, without CFTC mandate, such as monitoring trading activity to prevent market manipulation. You could adopt position limits, you could minimize conflicts of interest. So my question to you is why wait? Why wait for CFTC to mandate it? Why don't you just do it now?

Mr. VICE. Well, we are not waiting. We are doing it now. Those are substantial processes and systems to put in place. We are working on that now. Our goal is to put that in place as soon as possible. I think the Act had 180 days or 270 days. I don't even know. We are hopeful to have it in place much sooner than that. But it does take time to do.

Mr. CARDOZA. You can't give us, the Committee, an estimate today about when you are going to have those?

Mr. VICE. I can only tell you we are having to do something similarly for our European futures exchange, which, through a different no action process, now has similar requirements. There is a shorter time frame on that of 120 days, so eventually we are moving those projects along in tandem, and our hope is to have both of them in place by that time frame.

Mr. CARDOZA. Well, as usual, Mr. Chairman, I have several more questions, but no more time. So I will turn it back over to you.

The CHAIRMAN. I thank the gentleman. The gentleman from Minnesota.

Mr. WALZ. Thank you, Mr. Chairman. And thank you all for coming here today. And Mr. Zerzan, I am going to ask you a question. I know I am not piling on here. You are getting a lot of questions. And I think it is clear, and I appreciate Mr. Greenberger's point on speculation *versus* manipulation being very clear on this. Everyone up here is representing about 700,000 constituents for whom this is a major concern of theirs. We are trying to get to the heart of what this is, what the situation is, understanding that we need to have the fossil fuels, we need to understand the market needs to function and all of that. But there are some questions of if it is functioning correctly? So Mr. Zerzan, you have stated, and I read your testimony and heard you just shortly here, market forces supply and demand, not derivatives which are causing the commodity prices. My job is to weigh different sides of this.

So here are a couple of quotes. One that said, "We are in a mode where the fundamentals of supply and demand really don't drive the price." That was Lee Raymond at ExxonMobil. In December, somebody said, "The market is not controlled by supply and demand; it is totally controlled by speculators who consider oil as a financial asset." That was the Secretary General of OPEC. How do you respond to them, and how do I respond to constituents that when they are hearing some Members of this body give them simplistic solutions that are going to get us out of that? I am not look-

ing for a simplistic solution. I want to know what the role is. So how do you respond to that when you hear this?

Mr. ZERZAN. Well, Congressman, I read a report recently that had the clearest answer that I can think of, and it was a chart and it showed that the global daily demand for oil is about 87½ million barrels. And the global supply of oil is 86 million barrels. So until you see a point where supply and demand are in convergence, you are going to see increasing prices for oil, and there is simply no other way around it.

Mr. WALZ. And you think that the talk on speculation, I just received, as a member of the frequent flier miles at Northwest Airlines just sent out a letter to all of their customers, it says, "Since high oil prices are partly a response to normal market forces, the nation needs to focus on increased energy supply."

However, there is another side to this story because normal market forces are being dangerously amplified by poorly regulated market speculation. How do you respond to Northwest Airlines on that then.

Mr. ZERZAN. You know, there were a series of articles that have come out lately talking about Southwest Airlines, and how Southwest Airlines has been able to hedge the price of fuel going up by entering into over-the-counter derivatives, how they have gained price protection, and thus been able to keep their prices low. So when airlines send out notices like that, and several airlines have, I would simply say you probably should have gotten a swap agreement.

Mr. WALZ. What is the main role of the commodity markets? What are they supposed to do, in your opinion?

Mr. ZERZAN. Commodity markets primarily serve the purpose of informing market participants about prices.

Mr. WALZ. But now we have this entire class of hundreds of billions of dollars, pension funds, index funds, endowments and all of that, as a ways to bump up returns. And I am hearing you say that there is nothing involved in this. Just a few short years ago, $13 billion in this, now a new $260 billion headed maybe for a trillion. You don't think that change is going to have any impact on price at all; that capital?

Mr. ZERZAN. No. And frankly, there is a very simply way to illustrate this. If Mr. Vice and I decide that we are going to enter into an agreement whereby I am going to pay him $10 tomorrow and he is going to pay me the price of an umbrella tomorrow, the price of that contract is going to be determined based on whether or not it rains. If it rains tomorrow umbrellas are going to be $11 and he is going to owe me a buck. If it doesn't rain, I am going to owe him a buck because umbrellas are going to be $9, and we could go a billion of these contracts. But at the end of the day the price of the umbrella is determined by whether or not it rains. Commodity prices are determined by supply and demand. Derivatives allow you to manage that risk but they don't determine the price.

Mr. WALZ. So Exxon, my constituents, Northwest Airlines, everybody is wrong but the commodity traders.

Mr. ZERZAN. No, the commodity markets represent the price at which someone is willing to sell something and the price at which somebody is willing to buy something. And frankly, we have not

found a better method for figuring out what a price is than that. So people can decry the prices that they come up with. No one likes paying $5 for a gallon of gas. But at the end of the day, it is not the markets that caused that.

Mr. WALZ. Okay. I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas.

Mr. LAMPSON. Thank you, Mr. Chairman. And thank you for your indulgence and in allowing me to chair my own hearing going on in another building a few minutes ago. And I was unable to listen to the testimony, but I certainly appreciate you all being here, and what I am hearing I wish that I had heard more along the day. I will keep mine fairly simple and pretty quick, Mr. Chairman.

Mr. Greenberger, recently on National Public Radio, you said that there was one act of deregulation most to blame for the problems caused by financial derivatives, more to blame than the 1999 repeal of the Glass-Steagall Act is the Commodity Futures Modernization Act of 2000 introduced by then Senator Phil Gramm of Texas as a rider on to an 11,000 page omnibus bill that passed Congress just before it adjourned for Christmas in 2000. Who would you say, except for the drafters of this bill, or that bill, understood what this legislation did? And second, what effect would you say this bill had in contributing to the current financial crisis around the country?

Mr. GREENBERGER. It is my own belief that not many people understood what the impact of that bill was. There were endorsements of various parts of it. We are worried today if we re-regulate there will be unintended consequences. I would say the unintended consequences of that bill were enormous. Chairman Peterson disagreed with me earlier, but my assessment was, as a regulator, that before that bill passed, all energy futures, including the bilaterals that Mr. Zerzan is now talking about, if they are standardized, if they are standardized, and by the way, the International Swaps and Derivatives Association was the foremost proponent. They understood what that bill did, that they had to be traded on futures exchanges.

Now, if they were on futures exchanges we wouldn't be guessing is there speculation here, and who is doing what. There would be large trader data reporting coming to the CFTC. There would be spec limits that Dr. Newsome would be applying from his exchange. Those markets were functioning fine on December 20, 2000. We weren't holding hearings about whether there was excessive speculation. They allowed Mr. Vice's exchange to get started in some respects, for example, natural gas, to trade out of sight of the regulators. They allowed Enron, who was the proponent of it, to establish Enron On-Line, which has now been demonstrated through enforcement actions to have driven up the electricity costs on the West Coast by substantial numbers.

They allowed Amaranth, a hedge fund, to have its way, not a big hedge fund, but a hedge fund to drive up natural gas prices for 2 years until it got caught out. I believe because we don't know what is happening in the bilateral market, we don't know what is happening in the swaps market, we don't know what is happening on a lot of ICE's going on. We, my only suspicion is that things are not going on there that are helpful. Why do I suspect that? Because

I oversaw regulated markets for 2 years. And even on regulated markets, it is like the wild west if you don't police them. My fear is that when you take these markets, which this Act did, out of transparency, things that are not good for your constituents, Minnesota constituents or the airlines are happening, and we are spinning out of control.

Now, just my final point, and I am bearing in mind, Mr. Conaway's concern about my talking too much. My final point, is it deregulated the financial swaps market. When you go and look at the subprime meltdown, you will find credit default swaps were at the heart of that meltdown. And why is that? The mortgage lenders, the banks said to people who said, "Oh my gosh, you want us to buy a security in whether people who can afford to pay their mortgages are going to pay them? That doesn't make sense to us." And they said, "Not to worry. We are going to engage in a little swap here. You give us a premium and we will guarantee that you don't lose money." Well, the problem is, classically shown by Bear Stearns, the swaps dealer who was making the guarantee didn't have the money to pay off the guarantee. They thought housing prices would always go up. And when they went down there was no capital reserves. We are now holding $29 billion of those Bear Stearns obligations.

Mr. LAMPSON. Who understood that?

Mr. GREENBERGER. I would say there weren't enough people who understood what was going on there. I think at the time I did. I think at the time the International Swaps and Derivatives Association did. We were promised, Senator Gramm said when he introduced that thing, this would be a boon to the national economy, and here we are today.

Mr. LAMPSON. Thank you, Mr. Greenberger. Thank you, Mr. Chairman.

The CHAIRMAN. I thank you all. We just had votes called and we have been sitting here a long time. We thank the panel for coming in and sharing their time and expertise with us. We will recess the Committee and go over and do these votes. Hopefully you can grab a little lunch during the process. And we will have the second panel start immediately after the series of votes ends. The Committee is in recess.

[Recess.]

The CHAIRMAN. The Committee will come back to order. Do we have the witnesses? They are all here, are they? I would like to welcome the witnesses to the table.

This panel is going to examine pension funds and index funds, issues surrounding those areas. First of all, we have Ms. Robin Diamonte, Chief Investment Officer at the United Technologies Corporation on behalf of the Committee on Investment of Employee Benefit Assets; Dr. Scott Irwin, Professor of Department of Agriculture and Consumer Economics at the University of Illinois; Mr. Paul Cicio, President of the Industrial Energy Consumers of America. Mr. Jeffrey Korzenik——

Mr. KORZENIK. Korzenik.

The CHAIRMAN. I am a Norwegian. I can't say that.

Mr. KORZENIK. Wait until you get to the name of my firm, sir.

The CHAIRMAN.—Chief Investment Officer of VC&C Capital Advisers. And Dr. Craig Pirrong, who was on the panel previous. We would tell you that your full statements will be made part of the record. We would ask you to summarize and talk in layman language that we can understand as best you can. And we will have 5 minutes available for each of you. And Dr. Pirrong, you already gave your statement. We will just have four statements and then we will get to questions.

Ms. Diamonte, you are on.

**STATEMENT OF ROBIN L. DIAMONTE, CHAIRMAN, SUBCOMMITTEE ON DEFINED BENEFITS, COMMITTEE ON THE INVESTMENT OF EMPLOYEE BENEFIT ASSETS; CHIEF INVESTMENT OFFICER, UNITED TECHNOLOGIES CORPORATION, HARTFORD, CT**

Ms. DIAMONTE. Good afternoon, Mr. Chairman, Ranking Member Goodlatte, and others of the Committee. My name is Robin Diamonte, and I chair the Defined Benefits Subcommittee of CIEBA. Thank you for allowing us to testify on this very important subject. The Committee of Investment of Employee Benefit Assets, CIEBA, is the voice of the Association for Financial Professionals on employee benefit plan asset management and investment issues.

As the chief investment officers for most of the country's largest pension funds, CIEBA members manage more than $1.5 trillion of defined benefit and defined contribution plan assets on behalf of 17 million plan participants and beneficiaries nationwide. According to the Federal Reserve data, the $966 billion managed by CIEBA members in defined benefit plans represents half of all the private defined benefit plan assets.

The pension system has served millions of Americans for over half a century. We owe it to the working Americans and their families to ensure that any contemplated policy changes, no matter how well intentioned, do not undermine the retirement security.

The record prices for food and energy in the U.S. and abroad are of great concern to all of us. We are sensitive to the need to investigate this critical problem. Nonetheless, we are deeply concerned about the prospect of any legislation that would bar pension plans from investing in certain types of assets.

Congress has long recognized the direct government regulation of pension plan investments is ill-conceived. ERISA, the primary law that regulates the investment of pension assets, takes a very different approach. Rather than requiring or prohibiting specific investments, ERISA imposes rigorous fiduciary responsibilities on the persons that manage pension plan assets. These rules require a plan fiduciary to act prudently and to diversify planned investments so as to minimize the risk of large losses. In addition, ERISA requires that as a fiduciary, they act solely in the interest of plan participants and beneficiaries.

Today, private pension plans invest in a wide range of different asset classes. Plan fiduciaries use a variety of investment techniques and tools, including derivative instruments, to mitigate risk and enhance returns.

Other countries have taken different approaches to investments of pension assets. Some U.S. public plans and European defined

benefit plans have had rigid investment guidelines prohibiting certain types of investments and requiring others. Many of these rules have now been discarded because of the negative impacts such guidelines have on investment returns and thus on employees' retirement income.

Put simply, mechanical approaches do not work as well as the American approach of an investment flexibility paired with strict fiduciary obligations. It is critical that pension plans have the ability to invest in accordance with modern portfolio theory and pursue the best investment strategy available.

The investment marketplace is constantly changing and plans need to be able to adapt and evolve accordingly. Our concern is both with specific restrictions on pension plan investments and commodities and with the precedent that that action will set for allowing the government to intrude on pension investment decisions.

Today, commodity investments are not a significant part of most private sector plan portfolios. Preliminary results received through a 2007 profile survey show that plans have less than one percent of assets invested directly in commodities and natural resources combined. We firmly believe that commodities may be a part of a prudent, well diversified investment portfolio by providing a hedge against inflation and minimizing volatility, but our primary concern is with the principle that the government should not micromanage pension plan investments.

Political temptation to intervene in pension investments is not unprecedented. However, Congress has consistently rejected legislation that would subjugate the retirement security of millions of Americans and their families to other social or political concerns, no matter how worthy. In fact, when asked about economically targeted investments, the Department of Labor interpretation said, "That a fiduciary must not subordinate the interest of participants and beneficiaries to unrelated objectives."

Regulating pension investments would make it difficult for plans to adequately diversify investments to hedge against market volatility and inflation and consequently would put at risk the retirement funds of the very workers the proposal is intended to help. In effect, such a proposal could be a case of robbing Peter to pay Paul.

Again, thank you for the opportunity to testify. Please let me know if there is any additional information that you would like to receive from us.

[The prepared statement of Ms. Diamonte follows:]

PREPARED STATEMENT OF ROBIN L. DIAMONTE, CHAIRMAN, SUBCOMMITTEE ON DEFINED BENEFITS, COMMITTEE ON THE INVESTMENT OF EMPLOYEE BENEFIT ASSETS; CHIEF INVESTMENT OFFICER, UNITED TECHNOLOGIES CORPORATION, HARTFORD, CT

Mr. Chairman, Ranking Member Goodlatte, and other Members of the Committee, my name is Robin Diamonte and I am the Chairman of CIEBA's Subcommittee on Defined Benefits.

Thank you for providing this opportunity to testify. The Committee on Investment of Employee Benefit Assets—CIEBA—is the voice of the Association for Financial Professionals on employee benefit plan asset management and investment issues. CIEBA was formed in 1985 to provide a nationally recognized forum and voice for ERISA-governed corporate pension plan sponsors on fiduciary and investment issues. CIEBA members are the chief investment officers of most of the major pri-

vate sector retirement plans in the United States. CIEBA represents 110 of the country's largest pension funds and its members manage more than $1.5 trillion of defined benefit and defined contribution plan assets, on behalf of 17 million plan participants and beneficiaries nationwide. According to Federal Reserve data, the $966 billion managed by CIEBA members in defined benefit plans represents half of all private defined benefit plan assets.

The pension system has served millions of Americans for over half a century and tens of millions of retirees rely on defined benefit and defined contribution pension plans as a critical element of their retirement security. We owe it to working Americans and their families to ensure that any contemplated policy changes, no matter how well intentioned, do not undermine their retirement.

The record prices for food and energy in the U.S. and abroad are of great concern to all of us. We are sensitive to the urgency with which this issue must be addressed and we applaud the need to investigate this critical problem. Nonetheless, we are deeply concerned about the prospect of any legislation that would bar pension plans from investing in certain types of assets.

Congress has long recognized that direct government regulation of pension plan investments is ill-conceived. ERISA—the primary law that regulates the investment of pension assets—takes a very different tack. Rather than requiring or prohibiting specific investments, ERISA imposes rigorous fiduciary responsibilities on the persons that manage pension plan assets. These rules require a plan's fiduciary to act prudently, and to diversify plan investments so as to minimize the risk of large losses. In addition, ERISA requires that a fiduciary act solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits to the plan's participants. Fiduciaries who violate these obligations face a range of civil and criminal penalties.

The sole instance in which ERISA directly regulates pension investments is with respect to investments in employer securities—an area where there are clearly unique considerations, including potential conflicts of interest and the possibility of excessive concentrations of investment risk. In fact, private pension plans today invest in a wide range of different asset classes, including U.S. and international equities, U.S. and international fixed income, emerging markets, real estate, private equity, and natural resources. Plan fiduciaries use a variety of investment techniques and tools, including derivative instruments, to mitigate risk and enhance returns. Further, when presented with emerging asset classes and investment strategies, the Department of Labor—the Federal agency with oversight responsibility for pension investments—has consistently given its blessing as long as the investment is prudent and for the exclusive benefit of participants and beneficiaries.[1]

Other countries have taken different approaches to the investment of pension plan assets. Historically, some U.S. state government and some European defined benefit plans had rigid investment guidelines, prohibiting certain types of investments and requiring others. Many of these rigid investment rules were eventually discarded because of the negative impact such guidelines had on investment returns and thus on employees' retirement security. Even today, European pension funds subject to more restrictions on plan investments have been shown to be consistently outperformed by funds subject to regimes such as ours, which pair investment flexibility with strict fiduciary obligations. Put simply, mechanical approaches do not work as well as the American approach. It is critical that pension plans have the ability to invest in accordance with modern portfolio theory and pursue the best investment strategy available. The investment marketplace is constantly changing and pension plans need to be able to adapt and evolve accordingly without having to comply with lists of permitted and impermissible investments.

Our concern is both with specific restrictions on pension plan investments in commodities and with the precedent that action will set for allowing the government to intrude on pension investment decisions. Today, commodities investments are not a significant part of most pension plan investments. Preliminary results for CIEBA's 2007 profile survey show that plans have less than one percent of assets invested directly in commodities and natural resources. It may be that the actual percentage of assets invested in commodities is modestly greater through indirect investment vehicles, such as hedge funds. However, in total, CIEBA members reported that only 3.15 percent of their assets were invested in the broad category of hedge funds in 2006. We firmly believe that commodities may be part of a prudent, well-diversified investment portfolio by providing a hedge against inflation and minimizing volatility, but our primary concern is with the principle that the government should not micromanage pension plan investments.

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[1] *See, e.g.,* Department of Labor Information Letter to Eugene Ludwig, Comptroller of the Currency (Mar. 21, 1997) (permissibility of investing pension assets in derivatives).

Pension plans are long-term investors, not speculators. The most successful plans do not 'chase' returns. Rather they have disciplined strategies for minimizing risk and enhancing returns so that plan sponsors can fulfill the promises they make to their employees.

Political temptation to intervene in pension investments is not unprecedented. Congress in the past has considered legislation that would bar plans from investing in particular investments or, conversely, would require plans to invest in particular investments. There are numerous instances in which there has been a first instinct to require pension plans to make investment decisions with a view to promoting social or political goals, such as protecting the environment or stimulating business activity in certain geographic areas.

Congress, however, has consistently rejected legislation that would subjugate the retirement security of millions of Americans and their families to other social or political concerns, no matter how worthy. In fact, when confronted with whether pension plans may take into account social goals in considering economically targeted investments, the Department of Labor interpreted "the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives."[2]

Moreover, the case for limiting pension investments in commodities has simply not been made. As others, including the Commodity Futures Trading Commission ("CFTC"), have testified, it is far from clear that institutional investors in the commodities market are driving the surging prices. The allegations that institutional investors engage in harmful speculation in the commodities markets have been almost entirely anecdotal and we are not aware of any substantial analysis that supports the allegations. Before acting, it is imperative that Congress step carefully and allow the CFTC to analyze the commodities markets and gather data to facilitate an informed approach.

Various proposals to restrict investments in commodities do not define commodity investing with any specificity. If interpreted broadly, these restrictions could apply to direct investment in commodities, any commodities futures transactions, commodity indexes and even publicly-traded companies who produce or distribute energy or agricultural commodities. Compliance with such a prohibition would significantly disrupt pension plans' overall investments, thereby hurting plan participants.

Finally, regardless of one's view of whether institutional investors as a whole have been a driver of rising prices, it is apparent that pension investments have not been a material cause of the rising cost of food and energy. As previously mentioned, investments in commodities are a small fraction of CIEBA member pension funds' assets. Further, most plans will rebalance their investments periodically to assure that they stay within their guidelines and do not inadvertently get over-exposed to any single asset class. Plans with exposure to commodities or commodity indexes are very likely to sell when prices rise and buy when prices fall in an effort to maintain a constant weighting with respect to the whole portfolio.

Regulating pension investments would make it difficult for pension plans to adequately diversify investments to hedge against market volatility and inflation and, consequently, would put at risk the retirement funds of the very workers the proposal is intended to help. In effect, such a proposal could be a case of robbing Peter to pay Paul.

Again, thank you for this opportunity to testify. Please let me know if there is additional information that you would like to receive from us. We are happy to help you in any way we can.

The CHAIRMAN. Thank you very much. Dr. Irwin, I appreciate you being with us.

## STATEMENT OF SCOTT H. IRWIN, PH.D., PROFESSOR AND LAURENCE J. NORTON CHAIR OF AGRICULTURAL MARKETING, DEPARTMENT OF AGRICULTURAL AND CONSUMER ECONOMICS, UNIVERSITY OF ILLINOIS AT URBANA—CHAMPAIGN, URBANA, IL

Dr. IRWIN. Mr. Chairman, my name is Scott Irwin. I am a Professor in the Department of Agricultural and Consumer Economics

[2] 29 C.F.R. § 2509.94–2.

at the University of Illinois, and I have had a lifelong interest in commodities markets. I have been teaching and studying about commodity markets now for almost 30 years. And I also want to point out my interest is not merely academic, as I also help to manage our family farm in Iowa, and that gives me a real on-the-ground look at these questions as well.

As you are well aware, the impact of index funds on commodity prices is currently being hotly debated. It is commonly asserted that speculative buying by index funds and commodity future markets has created a bubble, with the result that market prices far exceed fundamental values. A number of bills have been introduced recently in Congress with the purpose of prohibiting or limiting index fund speculation in commodity futures markets.

And the first part of my remarks is devoted to the idea that there was a lot of discussion this morning about how things are new and changed, but I believe that there are, in fact, important lessons that we can draw from history. And it is interesting that a pervasive theme running through the history of U.S. futures markets is skepticism or out-and-out hostility about the role of speculators.

Rapidly increasing commodity prices at various times over the last 125 years have been accompanied by assorted attempts to curtail speculation. For example, just after World War II, soaring grain futures prices, especially for wheat, attracted political attention. In a statement that echoes those being made today, President Truman proclaimed that, "The cost of living in this country must not be a football to be kicked around by grain gamblers," and ordered the Commodity Exchange Authority, the precursor of the CFTC, to require futures exchanges to raise margins to 33 percent on all speculative positions. A truly extraordinary level.

Like the current time period, U.S. and international commodity markets during 1972 through 1975 experienced a period of rapid price increases. Commodity price increases were widely blamed on speculators and the growing futures industry. Following these price increases, public and political pressure to curb speculation resulted in a number of regulatory proposals and the upward adjustment of futures margin requirements.

In the boldest move against speculators and commodity futures, trade in onion futures was banned by the U.S. Congress in 1958. The ban, actually still in place, was due to the widespread belief that speculative activity created excessive price variation. Again, in language very similar to that heard today, a Congressional report stated that, "Speculative activity in the futures markets causes such severe and unwarranted fluctuations in the price of cash onions as to require a complete prohibition of onion futures trading in order to assure the orderly flow of onions in interstate commerce."

The evidence is thin at best that past attempts to limit the impact of speculation have had the desired effect on market prices. For instance, there is no historical evidence that directives to increase futures margins were effective at lowering overall price levels. The only consistently documented impact at the higher margin requirements was a decline in futures trading volume due to the increased cost of trading. So while proposals currently being consid-

ered might, in fact, curtail speculation through reduced volume of trading, it is very unlikely that the measures will cure the problem of high prices.

Let me now turn to a brief discussion of several facts that are inconsistent with the existence of a substantial bubble and commodity futures prices. First, let me note that for speculation to be considered excessive, it must be considered relative to the commercial hedging needs in the markets. The available data indicates that long speculation in commodity futures markets, including that by index funds, is not out of balance relative to short hedging by commercial firms.

Second, some commodity futures markets with high concentrations of index funds positions, such as livestock futures, have not experienced large increases in price. Very high prices have also been reserved for commodities without futures markets, such as durum wheat and edible beans and in futures markets that are not included in popular commodity indexes such as rice and fluid milk. It is difficult to rationalize why index fund trading would impact particular commodity markets and not others.

Third, inventories for some commodities such as grains and oilseeds have fallen sharply over the last 2 years while inventories of other commodities such as crude oil have stayed relatively flat or declined modestly. If index fund speculation creates bubbles in commodity futures prices, inventory should be rising, not falling or staying flat.

Fourth, index funds do not attempt to hide their current positions or their next move. It is highly unlikely that other large and well capped live speculators such as commodity trading advisors and hedge funds would allow index funds to push prices away from fundamental values when index trades are so easily anticipated.

In conclusion, long only index funds provide liquidity and risk bearing capacity for hedgers in commodity futures markets. It is possible that long only index funds impact future prices but the available evidence indicates that if there is any impact, it is likely to be small and fleeting. Therefore, policies aimed at curbing or eliminating speculation by index funds are likely to be counterproductive.

In contrast, policy initiatives that aim to improve the availability and transparency of information about index fund positions in commodity futures markets are more likely to be beneficial. The information gap is most glaring in the crude oil futures market, and if reliable data can be collected for this market, I believe it would go some distance towards addressing many of the questions currently being asked about the nature and impact of index fund trading.

Thank you for this opportunity to share this statement. I look forward to questions.

[The prepared statement of Dr. Irwin follows:]

PREPARED STATEMENT OF SCOTT H. IRWIN, PH.D., PROFESSOR AND LAURENCE J. NORTON CHAIR OF AGRICULTURAL MARKETING, DEPARTMENT OF AGRICULTURAL AND CONSUMER ECONOMICS, UNIVERSITY OF ILLINOIS AT URBANA—CHAMPAIGN, URBANA, IL

Mr. Chairman, my name is Scott Irwin. I am a Professor in the Department of Agricultural and Consumer Economics at the University of Illinois at Urbana—Champaign. I am also the holder of the Laurence J. Norton Chair of Agricultural

Marketing. Thank you for this opportunity to comment on the potential impacts of speculation by long-only index funds in commodity markets. As you are well aware, the impact of index funds on commodity prices is currently being hotly debated. Rising costs for energy and food are clearly a cause for general concern. It is commonly asserted that speculative buying by index funds in commodity futures markets has created a "bubble," with the result that market prices far exceed fundamental values. For example, it has been alleged at recent Congressional hearings that the "rampant" speculation by commodity index funds has driven the price of crude oil futures 25% or more above the true fundamental value of crude oil. A number of bills have been introduced recently in Congress with the purpose of prohibiting or limiting index fund speculation in commodity futures markets.

In my comments, I want to first point out the lessons we can learn from similar controversies about speculation in the past. Next, I will examine the available evidence on the balance between speculation and hedging in commodity futures markets over the last several years. Finally, I want to explore a number of facts about the current situation in commodity markets that are inconsistent with the existence of a substantial bubble in commodity futures prices.

A pervasive theme running through the history of U.S. futures markets is skepticism or out-and-out hostility about the role of speculators. Rapidly increasing commodity prices at various times over the last 125 years have been accompanied by assorted attempts to curtail speculation or control prices. For example, just after World War II, soaring grain futures prices, especially for wheat, attracted political attention. President Truman proclaimed that, "the cost of living in this country must not be a football to be kicked around by grain gamblers," and ordered the Commodity Exchange Authority (precursor to today's Commodity Futures Trading Commission) to require futures exchanges to raise margins to 33% on all speculative positions, a truly extraordinary level. In a statement that echoes those being made today, President Truman added, "If the grain exchanges refuse, the government may find it necessary to limit the amount of trading."

U.S. and international commodity markets during 1972–1975, like the current time period, experienced a period of rapid price increases, setting new all-time highs across a broad range of markets. Commodity price increases were widely blamed on speculators and the growing futures industry. Following these price increases, public and political pressure to curb speculation resulted in a number of regulatory proposals and the upward adjustment of futures margin requirements. These changes were accompanied by even more drastic measures—such as Federal price controls and an embargo against soybean exports—aimed at lowering commodity price levels.

In the boldest move against speculators in commodity futures, trade in onion futures was banned by the U.S. Congress in 1958. The ban, actually still in place, was due to the widespread belief that speculative activity created excessive price variation. Again, in language very similar to that heard today, a Congressional report stated that "speculative activity in the futures markets causes such severe and unwarranted fluctuations in the price of cash onions as to require complete prohibition of onion futures trading in order to assure the orderly flow of onions in interstate commerce."

The actions used to reign in supposedly damaging speculation in the past run the gamut from requiring futures exchanges to raise margins to an outright ban on futures trading. The historical evidence is thin, at best, that measures to limit the impact of speculation had the desired effect on market prices. For instance, there is no historical evidence that directives to increase futures margins were effective at lowering overall price levels. The only consistently documented impact of the higher margin requirements was a decline in futures trading volume due to the increased cost of trading. So, while proposals currently being considered might in fact curtail speculation—through reduced volume of trade—it is very unlikely that the measures will cure the "problem" of high prices. But, legislative and regulatory initiatives could severely compromise the ability of commodity futures markets to accommodate the needs of commercial firms to hedge price risks.

Let me now turn to available evidence on the balance between speculation and hedging in commodity futures markets over the last several years. The statistics on long-only index fund trading reported in the media and discussed at earlier Congressional hearings tend to view speculation in a vacuum—focusing on absolute position size and activity. As first pointed out by Holbrook Working back in the 1960's, an objective analysis of futures market activity must consider the balance between speculators and commercial firms hedging market risks. Instead of focusing solely on the question of "Who is doing all the speculative buying?" it is equally important to ask "Who is doing all of the short hedging?" A key insight from this framework is that speculation can only be considered 'excessive' relative to the level of hedging activity in the market.

A look at the data provided by the Commodity Futures Trading Commission (CFTC) is enlightening in this regard. *Table 1* shows the division of open interest for nine commodity futures markets for the first 3 months of 2006 and 2008. The four basic hedging and speculative positions are: HL = Hedging, Long; HS = Hedging, Short; SL = Speculating, Long; SS = Speculating, Short. Note that index fund traders are allocated almost exclusively to the HL category in *Table 1* and that HL + SL = HS + SS. There is an important omission from this table—crude oil futures. As the CFTC noted when it first began publishing data on index fund positions, it is difficult to separate out index fund transactions in energy markets because of the degree to which many firms in these markets engage in multiple trading activities that fall into different classifications and the degree to which firms engage in internal netting of these activities.

As expected, *Table 1* reveals that long speculation-driven by index funds—increased sharply in all but one of the nine commodity futures markets over January 2006 through April of 2008. However, the increase in short hedging generally was of similar magnitude or exceeded the increase in long speculation. Corn provides a pertinent example. Speculative buying in corn—including commodity index funds—increased by nearly 250,000 contracts; but, selling by commercial firms involved in the production and processing of corn increased by an even greater amount, around 500,000 contracts. While the increase in long-only index fund positions has received the most publicity, the increase in the size of short hedging positions is equally interesting. For instance, the position of short hedgers during the first quarter of 2008 in corn is equivalent to slightly less than 6 billion bushels, or about half the size of the expected 2008 crop.

The data in *Table 1* show that increases in long speculative positions tend to represent speculators trading with hedgers rather than speculators trading with other speculators. The former is considered beneficial to overall market performance since speculators are providing liquidity and risk-bearing capacity for hedgers, while the latter may be harmful since speculative trading is not connected to the risk transfer needs of hedgers. There is no pervasive evidence that current speculative levels, even after accounting for index trader positions, are substantially in excess of the hedging needs of commercial firms. In fact, long speculation in many cases is inadequate to balance the selling done by commercial firms. This result, though surprising to many, is consistent with the historical record for commodity futures markets.

If speculation is driving prices above fundamental values, the available data indicates it is not obvious in the level of speculation relative to hedging. Several other facts are inconsistent with the existence of a substantial bubble in commodity futures prices. *Figures 1* and *2*, respectively, show the increase in commodity futures prices over January 2006 through April 2008 and the average percent of open interest held by commodity index funds for the same time period. Note that data are presented for the same nine markets as in *Table 1.* The charts show that price increases are concentrated in grain and oilseed markets, but the highest concentration of index fund positions tend to be in cotton and livestock futures markets. This is the reverse of the relationship one would expect if index fund trading leads to bubbles in commodity prices. Very high prices have also been observed for commodities without futures markets, such as durum wheat and edible beans, and in futures markets that are not included in popular commodity indices tracked by index funds, such as rice and fluid milk. It is difficult to rationalize why index fund trading would impact particular commodity markets but not others.

Another stubborn fact has to do with inventories for storable commodities. If index fund speculation creates a bubble in futures prices for storable commodities, this also creates an incentive to store commodities because prices in the future exceed levels normally required to compensate inventory holders for storage. We should therefore observe an increase in inventories when a bubble is present. In fact, inventories for some commodities, such as grains and oilseeds, have fallen sharply over the last 2 years, while inventories of other commodities, such as crude oil, have stayed relatively flat or declined modestly. The behavior of commodity inventories is not consistent with large bubbles in commodity futures prices.

Still another difficult fact is the nature of commodity index trading. In order for any trader group to consistently push futures prices away from fundamental value their trading must be unpredictable. Otherwise, competing traders can easily anticipate the buying and selling by the group in question and profit by taking advantage of this knowledge. Index funds do not attempt to hide their current positions or their next move. Generally, funds that track a popular commodity index (*e.g.,* GSCI) publish their mechanical procedures for rolling to new contract months. Moreover, they usually indicate desired market weightings when the index is re-balanced. So, the only uncertainties stem from the overall in-flow or out-flow of money to index

funds. It is highly unlikely that other large and well-capitalized speculators, such as commodity trading advisors and hedge funds, would allow index funds to push prices away from fundamental values when index trades are so easily anticipated.

A related point is that large and long-lasting bubbles are less likely in markets where deviations from fundamental value can be readily arbitraged away. There are few limitations to arbitrage in commodity futures markets because the cost of trading is relatively low, trades can be executed literally by the minute, and gains and losses are marked-to-the-market daily. This stands in contrast to markets where arbitrage is more difficult, such as residential housing. The low likelihood of bubbles is also supported by numerous empirical studies on the efficiency of price discovery in commodity futures markets. The vast majority of studies indicate that commodity futures markets react efficiently to new information as it emerges. Where pricing problems have been documented, they are often associated with the delivery period of particular commodity futures contracts. However, as noted in the recent CFTC background memorandum on the application of its emergency powers, even this type of problem has been infrequent and relatively short-lived.

My position is that there is very limited hard evidence that anything other than economic fundamentals is driving the recent run-up in commodity prices. The main driving factors in the energy markets include strong demand from China, India, and other developing nations, a leveling out of crude oil production, a decrease in the responsiveness of consumers to price increases, and U.S. monetary policy. In the grain markets, driving factors also include demand growth from developing nations and U.S. monetary policy, as well as the diversion of row crops to biofuel production and weather-related production shortfalls. The complex interplay between these factors and how they impact commodity prices is often difficult to grasp in real-time and speculators historically have provided a convenient scapegoat for frustration with rising prices.

In conclusion, commodity market speculation by long-only index funds has increased markedly since 2006 in absolute terms. However, most commodity futures markets experienced an equally dramatic or even greater increase in selling by commercial hedgers. In these circumstances, speculative buying facilitates legitimate business transactions and enhances risk transfer for firms involved in commodity businesses. It is possible that long-only index funds impact futures prices, but the available evidence indicates that if there is any impact, it is likely to be small and fleeting. Therefore, policies aimed at curbing or eliminating speculation by index funds are likely to be counter-productive.

In contrast, policy initiatives that aim to improve the availability and transparency of information about index fund positions in commodity futures markets are laudable. There is a need to study and better understand the role of this new class of speculators in commodity futures markets. The information gap is most glaring in the crude oil futures market, and if reliable data can be collected for this market, I believe it would go some distance towards addressing many of the questions currently being asked about the nature and impact of index fund trading.

For a more detailed analysis of analysis of speculation in commodity futures, please see the following report:

> Sanders, D.R., S.H. Irwin, R.P. Merrin. "The Adequacy of Speculation in Agricultural Futures Markets: Too Much of a Good Thing?" Marketing and Outlook Research Report 2008–02, Department of Agricultural and Consumer Economics, University of Illinois at Urbana—Champaign, June 2008.

The report can be downloaded on the Internet at:

*http://www.farmdoc.uiuc.edu/marketing/morr/morr_08-02/morr_08-02.pdf.*

Table 1. Speculative and Hedging Positions in Commodity Futures Contracts During the First Quarter of 2006 and First Quarter of 2008

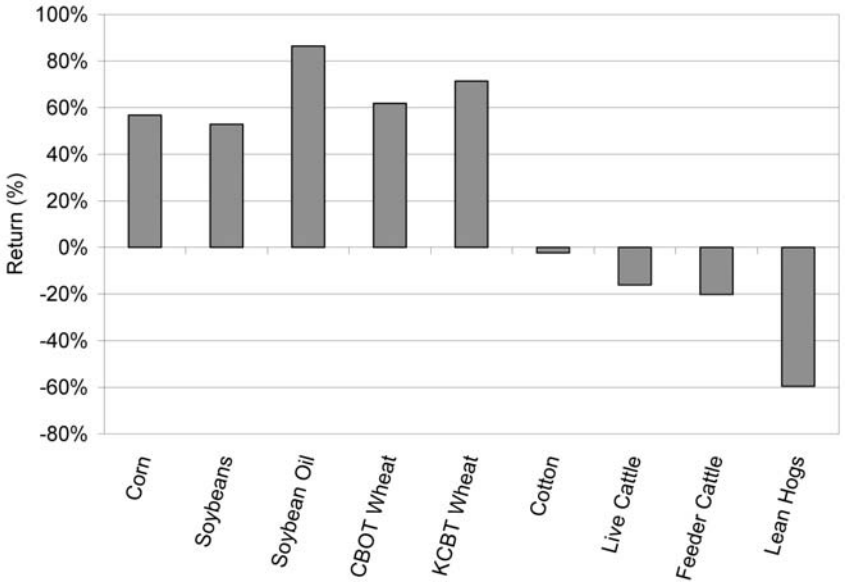
| Market | HL | HS | SL | SS |
|---|---|---|---|---|
| | —# of contracts— | | | |
| Corn: | | | | |
| 2006 | 328,362 | 654,461 | 558,600 | 208,043 |
| 2008 | 598,790 | 1,179,932 | 792,368 | 182,291 |
| Change | 270,428 | 525,471 | 233,768 | −25,752 |
| Soybeans: | | | | |

Table 1. Speculative and Hedging Positions in Commodity Futures Contracts During the First Quarter of 2006 and First Quarter of 2008—Continued

| Market | HL | HS | SL | SS |
|---|---|---|---|---|
| | —# of contracts— | | | |
| 2006 | 126,832 | 192,218 | 183,105 | 107,221 |
| 2008 | 175,973 | 440,793 | 351,379 | 74,844 |
| Change | 49,141 | 248,575 | 168,274 | −32,377 |
| Soybean Oil: | | | | |
| 2006 | 66,636 | 124,134 | 92,515 | 35,599 |
| 2008 | 121,196 | 228,515 | 128,546 | 25,844 |
| Change | 54,560 | 104,381 | 36,032 | −9,755 |
| CBOT Wheat: | | | | |
| 2006 | 57,942 | 213,278 | 251,926 | 92,148 |
| 2008 | 70,084 | 240,864 | 300,880 | 121,578 |
| Change | 12,141 | 27,585 | 48,954 | 29,430 |
| KCBT Wheat: | | | | |
| 2006 | 43,993 | 110,601 | 80,158 | 13,560 |
| 2008 | 46,459 | 96,556 | 67,827 | 15,767 |
| Change | 2,466 | −14,045 | −12,330 | 2,207 |
| Cotton: | | | | |
| 2006 | 41,582 | 108,085 | 86,777 | 21,824 |
| 2008 | 107,826 | 296,434 | 200,773 | 18,918 |
| Change | 66,244 | 188,349 | 113,995 | −2,906 |
| Live Cattle: | | | | |
| 2006 | 54,549 | 128,951 | 129,786 | 45,305 |
| 2008 | 34,970 | 144,549 | 198,211 | 80,303 |
| Change | −19,579 | 15,599 | 68,425 | 34,998 |
| Feeder Cattle: | | | | |
| 2006 | 10,707 | 17,725 | 20,769 | 10,632 |
| 2008 | 6,310 | 13,435 | 28,284 | 18,111 |
| Change | −4,397 | −4,290 | 7,515 | 7,479 |
| Lean Hogs: | | | | |
| 2006 | 15,949 | 65,438 | 93,522 | 40,036 |
| 2008 | 36,825 | 113,971 | 149,415 | 69,055 |
| Change | 20,876 | 48,533 | 55,893 | 29,019 |

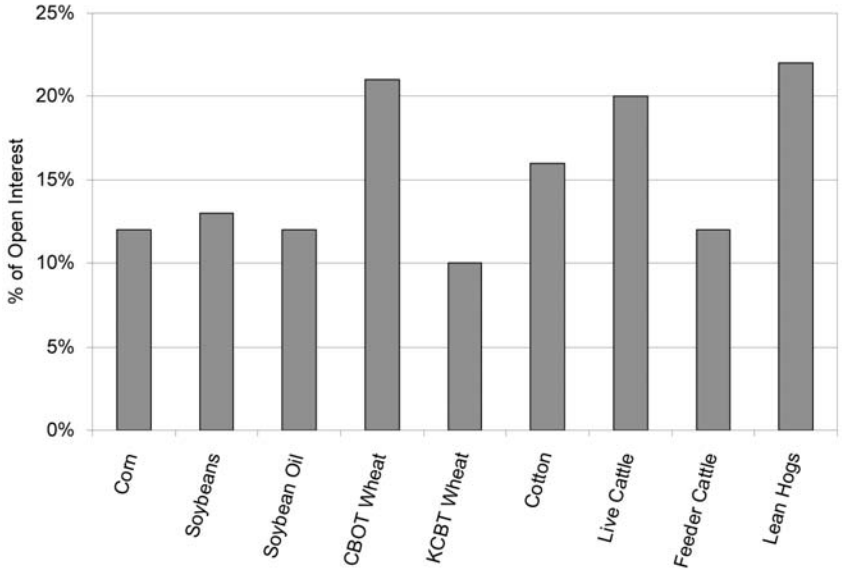
Notes: HL = Hedging, Long; HS = Hedging, Short; SL = Speculating, Long; SS = Speculating, Short. Long-only index fund positions are classified as speculative. The data reflect average positions in the first calendar quarter of 2006 and 2008, respectively. Source: Sanders, Irwin, and Merrin (2008).

**Figure 1. Percent Change (return) in Commodity Futures Prices, 2006–2008.**




Notes: The returns are the cumulative Tuesday-to-Tuesday log-relative price changes for nearby futures contracts for the weeks ending January 3, 2006 to April 15, 2008. Price changes and returns are adjusted for contract roll over. Source: Sanders, Irwin, and Merrin (2008).

**Figure 2. Average Percent of Open Interest Held by Index Funds in Commodity Futures Markets, 2006–2008.**




Source: Sanders, Irwin, and Merrin (2008).

The CHAIRMAN. Thank you very much, Dr. Irwin. Mr. Cicio.

**STATEMENT OF PAUL N. CICIO, PRESIDENT, INDUSTRIAL ENERGY CONSUMERS OF AMERICA, WASHINGTON, D.C.**

Mr. CICIO. Thank you, Mr. Chairman, Members of the Committee, for the opportunity to testify before you. My name is Paul Cicio, and I am President of the Industrial Energy Consumers of America, a trade association and consumer advocate for manufacturing companies who are significant consumers of energy.

Mr. Chairman, I have a letter here from the President and CEO of Tyson Foods, a member of my organization, that we would like to submit for the record.

The CHAIRMAN. Without objection, so ordered.

Mr. CICIO. Thank you.

Consistent with my testimony today, Tyson Foods says they are very concerned about the impact that noncommercial traders and index funds are having on the agricultural markets and urges reform to deal with excessive speculation in both ag and energy commodities.

Mr. Chairman, we believe that Congress must decide whether it supports families and American manufacturing businesses and jobs, or index funds, hedge funds, pension funds, sovereign funds and exchanges. It is just that simple.

Consumers across the nation are asking for proof that index funds and Wall Street firms are not playing a role in causing the significant rise in commodity prices. The burden of proof is on the speculator, not on the consumer.

Each monthly commodity price is based on a given supply of physical product. Think of each individual commodity as having a swimming pool filled with product for delivery that month, but more and more people jump into that pool. That is what has happened to the commodity markets. In just 3 short years, index funds have increased from almost nothing to $260 billion and each month more and more are jumping into that same pool, which has created a speculative bubble and higher resulting prices. To consumers it appears that speculative bubble has benefited the few at the cost of many, the American public and manufacturing.

We believe there is a speculative bubble. The bubble will eventually burst and prices will fall, either by government action or by demand destruction. We urge government action. No action on the part of Congress will result in continued demand destruction by the price sensitive manufacturing industries that belong to my organization. Higher prices will continue to shut down manufacturing plants.

Higher energy costs have already significantly contributed to the loss of 3.3 million manufacturing jobs since 2000, and we have already lost 350,000 jobs just this year. We have lost 19 percent of all manufacturing jobs since the year 2000. For IECA companies who use large quantities of natural gas, we want proof that index funds have not increased natural gas prices that have risen 128 percent in 1 year when domestic supply has increased 7.1 percent in that same time period and is continuing to increase and is in balance with demand for that same time period.

And national inventories currently stand adequately at just below the 5 year average; there has not been any supply disruptions; and 85 percent of the market is supplied domestically. U.S. natural gas prices are not linked to crude oil prices and are not impacted by international supply disruptions of crude oil, yet prices have surged along with crude prices. If index funds did not cause the price increase, we want to know what did. And we would ask the Committee to help us.

We would like to point out that prior to the year 2000, before CMFA, the futures market worked efficiently without index funds and any changes to price were confidently the result of supply and demand issues. We want that confidence back. Index funds were not needed to make markets work before and they are not needed now. We encourage you to restore that confidence by returning these markets to physical producer/consumer hedgers and eliminate index fund participation.

NYMEX is on record saying the index funds are not driving up the price of commodities. Our question is, prove it. NYMEX trading volumes are estimated by many to be as little as 25 percent of the trading volume. Plus NYMEX is in the business of making money based on higher trading volumes. Given this, we put little credibility on that testimony.

The CFTC is on record saying that index funds are not driving up the price of commodities. If the CFTC has proof, we would like to see it. Given that CFTC has admitted to having very limited access to volumes of trades in dark markets, which are estimated to be three to four times the size of NYMEX volumes, we have a very hard time understanding how the CFTC can confidently say that index funds are not playing a role.

In closing, Mr. Chairman, doing nothing creates demand destruction and loss of jobs by the manufacturing sector. We urge action to increase transparency, place limits on speculation that is responsible and set responsible position limits.

Thank you.

[The prepared statement of Mr. Cicio follows:]

PREPARED STATEMENT OF PAUL N. CICIO, PRESIDENT, INDUSTRIAL ENERGY CONSUMERS OF AMERICA, WASHINGTON, D.C.

Mr. Chairman and Members of the Committee,

My name is Paul N. Cicio. I am President of the Industrial Energy Consumers of America. Thank you for the opportunity to testify before you on the important issue of excessive speculation in energy and commodity markets in general.

IECA is a 501(C)(6) national non-profit non-partisan cross-industry trade association whose membership is exclusively from the manufacturing sector.

IECA promotes the interests of manufacturing companies for which the availability, use and cost of energy, power or feedstock play a significant role in their ability to compete in domestic and world markets. IECA membership represents a diverse set of industries including: plastics, cement, paper, food processing, aluminum, chemicals, fertilizer, brick, rubber, insulation, steel, glass, industrial gases, pharmaceutical, construction products, automotive products, and brewing.

**Immediate action by Congress is needed to eliminate excessive speculation in energy and food related futures markets and increase domestic energy production.**

At the heart of the matter is that every consumer in the country assumes that the government is protecting their interests and that commodity markets are operating with the public's interest at heart. Nothing could be further from the truth. The futures market that is relied upon for price determination in the spot physical

market no longer reflects underlying supply and demand fundamentals. Existing law and government institutions that are in place have failed to protect the public interest. Excessive levels of speculation are un-necessarily raising the costs of energy for every homeowner, farmer and manufacturer.

We urge the Congress to take action to eliminate excessive speculation in futures markets and to increase the domestic supply of energy. Removing excessive speculation will have an immediate short term impact on commodity prices. The Congress cannot under-estimate the impact this issue is having on our country through unnecessary high energy costs and inflationary impacts. Make no mistake that excessive speculation is occurring and futures markets have become over-run with players that futures markets never intended as participants.

For energy, taking action to remove the moratorium on the Outer Continental Shelf and provide access to the Alaskan National Wildlife Refuge Reserve (ANWR) will increase domestic supply of natural gas and oil in coming years. The combination of eliminating excessive speculation, increasing domestic production, implementing cost effective energy efficiency and responsible conservation will go a long way in solving our nation's energy crisis.

The manufacturing sector is dependent upon globally competitive energy to compete in the market place. We are substantial consumers of natural gas for fuel and feedstock and also use large quantities of electricity.

The high price of natural gas has significantly contributed to the loss of manufacturing jobs. Since 2000, 3.3 million manufacturing jobs have been lost which account for 19 percent of all manufacturing jobs. According to the July 4, 2008 *USA Today,* manufacturers lost 33,000 jobs in the month of June alone. It also reports that U.S. manufacturers have lost 353,000 jobs so far this year despite the weak dollar that has helped to make exports more cost competitive.

It is also important to note that natural gas prices set the marginal price of electricity in a growing portion of the country. As natural gas prices rise, so does the price of electricity. The two are connected and the increase in the price of electricity is another unintended consequence of higher natural gas prices because of excessive speculation. High natural gas and electricity prices are resulting in a new round of demand destruction that drives high paying manufacturing jobs offshore.

**The case for natural gas.**

U.S. natural gas prices are not linked to crude oil prices and are not impacted by international supply disruption concerns, yet prices have surged along side crude prices in recent months.

Unlike crude oil that is priced globally, natural gas is a North American market and is priced domestically. In most years, we produce about 82 percent of our natural gas in the U.S., import about 15 percent from Canada and import about three percent in the form of LNG. If global demand for crude oil exceeds supply, the price will rise globally. If demand for natural gas rises or falls in the U.S., only U.S. consumers will pay either higher or lower prices. Crude oil and natural gas pricing are distinct and separate and there is insignificant substitution capacity. Natural gas prices are disconnected to crude oil prices in the physical markets.

There is no shortage of U.S. natural gas. Domestic supply is meeting demand and expanding slowly. National inventories are slightly below their 5 year average; LNG import capacity has increased and is greatly under-utilized. There have not been any hurricanes or production stoppages. However, despite this fairly stable supply and demand picture, the price of natural gas has soared.

From 1 year ago, the price of natural gas has risen from $5.94 mm Btu to $13.58 mm Btu, a 129 percent increase. Why, then, has the price of natural gas risen so high so quickly? The answer is that larger and larger quantities of capital have flowed into the futures markets by means of index funds, institutional investors like pension funds, hedge funds and sovereign funds.

To illustrate the point we have compiled the following information. Using EIA 2007 data, the U.S. consumes on average 1,971,357,597 MM Btus of natural gas per month. On July 3, 2008 50,731 natural gas contracts were traded on the NYMEX for the August contract. At this rate, the NYMEX trading activity in the prompt month (August) is eight times the total U.S. monthly average consumption volume. But this is only the NYMEX volume. It is a widely held view that the Over-the-Counter (OTC) markets, the dark markets, trade three to four times the volume that is traded on NYMEX. If the OTC market is three times larger, natural gas traded volume is greater than 24 times the physical consumption. What is frightening is that the rate of trading volume continues to rise.

**Excessive speculation must be stopped.**

There is no question that excessive speculation has increased the price of energy and commodities in general. Trading volumes are now reportedly 22 times that of

the underlying commodity volumes and, as a result, speculators are trading with other speculators with no regard to the underlying supply *versus* demand fundamentals.

According to one estimate, assets allocated to commodity index trading strategies have risen from $13 billion from 2003 to about $260 billion in early 2008. Futures markets were never intended to be used as an inflation hedge or an asset class. Futures markets were established to serve price discovery for sellers and buyers of the commodity.

We strongly encourage you to include provisions that will do the following.

1. Ensure only *bona fide* physical hedgers qualify for hedge exemptions.

Direct the CFTC to re-examine the definition of "hedging" to ensure that hedge exemptions are only available to *bona fide* hedgers and not to speculators. This will prevent speculators from using this exemption to avoid position limits.

2. Prohibit pension funds, index funds funds from speculating in commodity markets.

Futures were never intended to be used as an asset class for investment purposes. Using futures as an 'asset class' to hedge against inflation or to feather the performance of pension funds destroys the underlying functioning and efficiency of price determination for which we rely on futures. In the past, gold was used as a hedge against inflation, but using energy or food commodities directly and negatively damage families, farmers and manufacturers. The Congress must decide whether it supports families and American businesses or hedge funds, pension funds and sovereign funds. It's just that simple.

3. Fully close the Enron loophole.

Require that all energy exchanges be subject to appropriate Federal regulation, including reporting requirements and position limits, by prohibiting any energy contracts from being traded on exempt commercial markets. This includes Swaps. Speculative position limits must "look-through" the swaps transaction to the ultimate counterparty and hold that counterparty to the speculative limits.

4. Close the foreign exchange loophole:

(a) Require all foreign exchanges offering energy commodities through a U.S.-based terminal to be subject to the same regulatory requirements applicable to U.S. exchanges, including position limits, margin requirements, and reporting.

(b) Subject U.S. traders trading energy derivatives on non-U.S. markets to the same reporting and record-keeping requirements as those trading on U.S. exchanges. This prevents them from avoiding CFTC oversight by trading oversees.

5. Provide greater transparency on energy swaps.

Direct the CFTC to impose reasonable record-keeping and 'large trader' reporting requirements on all energy swaps made in the U.S. or made by U.S. traders anywhere in the world, while taking steps to ensure that participants' information is kept confidential and not disclosed to competitors.

6. Enhanced reporting requirements.

Direct the CFTC to devise new classifications of trades to break out speculators or swaps as a separate category, and direct the CFTC to enhance its Commitments of Traders reports to include trades using the Intercontinental Exchange (ICE) in Europe and other similar exchanges.

7. Disclosure requirements.

Require companies who promote market positions (such as market analysts) to disclose their positions if they talk publicly. Or ban conflict of interest such as analysts' statements that enrich analyst's portfolios.

8. Lower position limits and margin policies to benefit physical hedgers.

We believe that individual entities from the hedge funds, index funds, and sovereign funds can provide more capital for trading then most energy producers or sellers. It is paramount that we prevent a few entities from developing market power.

9. Identify sovereign fund positions.

Require the CFTC large trader report to identify sovereign funds and their positions. The participation of sovereign funds in commodity markets must be made clear to the CFTC because financial derivative price movements have a direct impact on the price of the physical commodity. A cause and effect.

10. All companies must register and file reports to Security Exchange Commission.

Require all companies who participate in U.S. commodity markets, including hedge funds, to register and file reports to the Security Exchange Commission just like all other companies.

11. Ensure that the banks are not borrowing capital from the Federal Reserve at low interest rates to speculate in the futures market.

We encourage the Congress to ensure that Federal Reserve monetary policy is not causing higher energy and food costs by providing cheap money to banks to speculate on commodities. Attached charts show an almost linear relationship between lower Federal Reserve interest rates, increased borrowing by banks and corresponding higher commodity prices. We are concerned that the timing is not coincidental.

Thank you.

APPENDIX

| Intended federal funds rate | | | |
|---|---|---|---|
| Change and level, 1990 to present | | | |
| Change | | | |
| (basis points) | | | |
| Date | Increase | Decrease | Level (percent) |
| 2008 | | | |
| 30-Apr | ... | 25 | 2 |
| 18-Mar | ... | 75 | 2.25 |
| 30-Jan | ... | 50 | 3 |
| 22-Jan | ... | 75 | 3.5 |
| 2007 | | | |
| 11-Dec | ... | 25 | 4.25 |
| 31-Oct | ... | 25 | 4.5 |
| 18-Sep | ... | 50 | 4.75 |
| 2006 | | | |
| 29-Jun | 25 | ... | 5.25 |
| 10-May | 25 | ... | 5 |
| 28-Mar | 25 | ... | 4.75 |
| 31-Jan | 25 | ... | 4.5 |

%FF [10] - FED FUNDS 30 DAY (DAY)
LAST: 97.995
CHANGE: ▲ 0.005
HIGH: 97.995
LOW: 97.995
6/23/2008
Charts sponsored by:
MF Global
Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec '08 Feb Mar Apr May Jun Daily

%NG [30] - NATURAL GAS
LAST: 13.26
CHANGE: ▲ 0.26
HIGH: 13.26
LOW: 13.02
6/23/2008
Chart of FF
Charts sponsored by:
MF Global
Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec '08 Feb Mar Apr May Jun Daily

SUBMITTED STATEMENT OF RICHARD L. BOND, PRESIDENT AND CEO, TYSON FOODS, INC., SPRINGDALE, AR

July 9, 2008

Hon. COLLIN C. PETERSON,
*Chairman,*
Committee on Agriculture,
U.S. House of Representatives,
Washington, D.C.;

Hon. BOB GOODLATTE,
*Ranking Minority Member,*
Committee on Agriculture,
U.S. House of Representatives,
Washington, D.C.

Dear Chairman Peterson and Ranking Member Goodlatte:

I commend the Committee for its attention to the critical issue of excessive speculation in the commodity markets and want to offer the view of Tyson Foods, Inc. on possible actions to remedy this problem.

As you know, we have seen tremendous increases in the cost of grains as well as energies over the last few years. While attributable to a number of factors, Tyson Foods is very concerned with the impact that noncommercial traders and index funds are having on the agricultural commodity markets. As of June 17th, open interest in corn futures has increased 114 percent over the last 3 years and open interest in soybeans has jumped 93 percent. Wheat has also seen considerable growth. All of these numbers are in excess of the growth we have seen in crude oil.

Looking closer, if you examine the June 17th Commitment of Traders report, which is attached, you will note that overall corn holdings for noncommercial and index funds are equivalent to roughly 32 percent ownership of the estimated production for this year's crop. These are market participants that do not physically use these commodities. We are very concerned that the percentage holding in corn will only continue to grow. We base that concern on the premise that participation from the noncommercial and index funds in other agricultural markets is already higher than in corn. For example, soybean holdings for noncommercial and index funds are almost 50 percent of estimated production for this year's crop and for wheat, the percentages are even higher.

While the energy markets have rightly received a tremendous amount of attention in recent months, we are convinced that the data shows that excessive speculation is a problem in many of the markets under the CFTC's jurisdiction. For this reason, Tyson Foods urges that any reforms considered by this Committee and ultimately adopted by the House of Representatives be applied to all commodity markets and not just the energy markets. A standardized approach to all commodity markets to reduce the role of excessive speculation is warranted.

To be clear, Tyson Foods does recognize the necessary role of speculation in the commodity markets and does not support banning particular participants from these markets. We recognize that speculators provide liquidity to the commodity markets but believe that they must provide that liquidity with transparency and under clearly defined limits. For this reason, we urge strong action to address excessive speculation, including:

- Ensuring that only true physical hedgers qualify for hedge exemptions—hedge exemptions should be available only to true hedgers that have a physical underlying exposure to a commodity. Speculators should not be allowed to use this exemption to avoid position limits. For example, a financial trading subsidiary for an investment bank or an index fund should not qualify for a hedge exemption. Neither entity has a natural long physical ownership or short physical need for commodities.
- Fully closing the Enron Loophole—all commodity exchanges should be subject to appropriate reporting requirements and position limits, no commodity contracts should be traded on exempt commercial markets.
- Providing greater transparency on commodity swaps—the CFTC should be directed to impose reasonable record-keeping and reporting requirements on all commodity swaps made in the U.S. or made by U.S. traders anywhere in the world.
- Requiring enhanced reporting requirements—the CFTC should be directed to devise new classifications of trades to break out index speculators or swaps as a separate category.

- Closing the foreign exchange loophole—all foreign exchanges offering commodities through a U.S.-based terminal should be subject to the same regulatory requirements applicable to U.S. exchanges, including position limits, margin requirements, and reporting. Further, U.S. traders trading on non-U.S. markets should also be held to the same regulatory requirements as those trading on U.S. exchanges.

I appreciate this opportunity to offer Tyson Foods' views on excess speculation in the commodity markets and thank the Committee for its thorough examination of this important issue. If you require any additional information related to my comments please do not hesitate to contact me.

Sincerely,

RICHARD L. BOND.

**Supporting Information**

Fund Involvement Analysis - Option and Futures Combined Positions

| Non-Comm | | Index | | Total Fund Involvement | | US Production (2008-09)[a] | Long Only Fund Position as % of Crop |
|---|---|---|---|---|---|---|---|
| Long | Short | Long | Short | Positions | Bushels | | |
| CORN | | | | | | | |
| 267,689 | 69,216 | 486,195 | 55,654 | 753,884 | 3,769,420,000 | 11,735,000,000 | 32.1% |
| WHEAT (Chicago) | | | | | | | |
| 51,381 | 77,475 | 216,643 | 36,613 | 268,024 | 1,340,120,000 | 2,432,000,000 | 55.1% |
| WHEAT (Total) | | | | | | | |
| 68,290 | 86,692 | 247,592 | 37,374 | 315,882 | 1,579,410,000 | 2,432,000,000 | 64.9% |
| SOYBEANS | | | | | | | |
| 121,933 | 26,919 | 187,210 | 14,525 | 309,143 | 1,545,715,000 | 3,105,000,000 | 49.8% |

[a] June 2008 WASDE Report.

Non commercial - tradtional large speculator, hedge fund, black box, in and out trading

Index funds - funds tied to index (GSCI) long only funds, mutual funds

Open Interest Comparisons

Weekly Comparison Based on 6/17/08 Report:

Week Percentage Change (as of 6/17/08)

| | | 3-month | 6-month | 1-year | 3-year |
|---|---|---|---|---|---|
| CBOT Corn | Open Interest | -0.08% | 16.59% | 12.69% | 104.90% |
| | Price | 38.41% | 67.85% | 87.36% | 229.74% |
| CBOT Soybean | Open Interest | -6.75% | -14.24% | -10.82% | 64.94% |
| | Price | 21.82% | 33.12% | 86.67% | 120.90% |
| CBOT Wheat | Open Interest | -10.96% | -15.05% | -11.88% | 64.08% |
| | Price | -18.73% | -7.68% | 48.27% | 175.99% |
| NYMEX Crude Oil | Open Interest | -5.13% | 0.37% | -6.16% | 65.42% |
| | Price | 27.54% | 47.10% | 95.21% | 138.89% |

Comparison Based on First 6 Months of Year:

Percentage Change (Jan-Jun Average, 2008 vs prior years)

| | | 2007 | 2006 | 2005 |
|---|---|---|---|---|
| CBOT Corn | Open Interest | 3.93% | 26.53% | 113.98% |
| | Price | 47.21% | 146.73% | 171.63% |
| CBOT Soybean | Open Interest | 11.61% | 47.73% | 92.50% |
| | Price | 78.20% | 131.26% | 120.10% |
| CBOT Wheat | Open Interest | -1.71% | -1.37% | 86.74% |
| | Price | 91.37% | 157.23% | 194.15% |
| NYMEX Crude Oil | Open Interest | 4.44% | 43.17% | 77.97% |
| | Price | 78.54% | 63.78% | 112.44% |

## Commitments of Non-Commercial and Index Traders Compared to Market Size

Commitments data from CFTC Commitments of Traders Report, Positions as of July 1, 2008
Fundamental data from USDA World Agricultural Supply and Demand Report, June, 2008

### Cotton

| | | |
|---|---|---|
| Non-Commercial Net Long | 2.9 | mil bales |
| Index Trader Net Long | 10.5 | mil bales |
| Non-Commercial plus Index Trader Net Long | 13.4 | mil bales |
| Crop | 19.2 | mil bales |
| Carryout | 10.2 | mil bales |
| Open Interest | 37.8 | mil bales |

Non-Commercial plus Index Trader Net Long
As a Percent of:

| | | |
|---|---|---|
| Crop | 70 | % |
| Carryout | 131 | % |
| Open Interest | 35 | % |

### Corn

| | | |
|---|---|---|
| Non-Commercial Net Long | 923 | mil bu |
| Index Trader Net Long | 2086 | mil bu |
| Non-Commercial plus Index Trader Net Long | 3009 | mil bu |
| Crop | 13100 | mil bu |
| Carryout | 1400 | mil bu |
| Open Interest | 10000 | mil bu |

Non-Commercial plus Index Trader Net Long
As a Percent of:

| | | |
|---|---|---|
| Crop | 23 | % |
| Carryout | 215 | % |
| Open Interest | 30 | % |

### Soybeans

| | | |
|---|---|---|
| Non-Commercial Net Long | 464 | mil bu |
| Index Trader Net Long | 845 | mil bu |
| Non-Commercial plus Index Trader Net Long | 1309 | mil bu |
| Crop | 2600 | mil bu |
| Carryout | 125 | mil bu |
| Open Interest | 3270 | mil bu |

Non-Commercial plus Index Trader Net Long
As a Percent of:

| | | |
|---|---|---|
| Crop | 50 | % |
| Carryout | 1047 | % |
| Open Interest | 40 | % |

**Chicago Wheat (Soft Red)**

| | | |
|---|---|---|
| Non-Commercial Net Long | -99 | mil bu |
| Index Trader Net Long | 889 | mil bu |
| Non-Commercial plus Index Trader Net Long | 790 | mil bu |
| Crop | 350 | mil bu |
| Carryout | 46 | mil bu |
| Open Interest | 2200 | mil bu |

Non-Commercial plus Index Trader Net Long
As a Percent of:

| | | |
|---|---|---|
| Crop | 226 | % |
| Carryout | 1717 | % |
| Open Interest | 36 | % |

**Kansas City Wheat (Hard Winter)**

| | | |
|---|---|---|
| Non-Commercial Net Long | 19 | mil bu |
| Index Trader Net Long | 139 | mil bu |
| Non-Commercial plus Index Trader Net Long | 158 | mil bu |
| Crop | 962 | mil bu |
| Carryout | 106 | mil bu |
| Open Interest | 525 | mil bu |

Non-Commercial plus Index Trader Net Long
As a Percent of:

| | | |
|---|---|---|
| Crop | 16 | % |
| Carryout | 150 | % |
| Open Interest | 30 | % |

The CHAIRMAN. Thank you very much. Jeff.

**STATEMENT OF JEFFREY D. KORZENIK, CHIEF INVESTMENT OFFICER, VC&C CAPITAL ADVISERS, LLC, VITALE, CATURANO & COMPANY, LTD., BOSTON, MA**

Mr. KORZENIK. That is fine. Thank you, sir.

The CHAIRMAN. We appreciate you being with us.

Mr. KORZENIK. I am pleased to be here. Thank you, Mr. Chairman and Members of the Committee. My name is Jeff Korzenik. I am the Chief Investment Officer of Vitale, Caturano & Company in Boston, and they are a registered investment adviser, VC&C Capital Advisers. My background with commodities and derivatives goes back 22 years; however, I don't believe that my firm or I would benefit or be harmed by the policy changes being considered.

Until now I have never testified before Congress. I don't think I have even stood up at a town meeting, my local form of government. But I am here today because when I first began examining this issue, I came to the conclusion this was a public policy concern.

The largest drivers of recent commodity price inflation are almost certainly demand growth from developing economies and weakness in the dollar. In the long run, too, markets find their

price level based on commercial production, usage and inventory changes.

In short to intermediate periods, however, speculators can be disruptive, influencing prices and hurting consumers. Pension and index investment has become a third force in stoking commodity inflation and damaging the structural integrity of the futures markets. Their activities can fairly be said to represent excessive speculation. These new participants, and I am going to follow the lead of others, are commonly called index speculators. When I use terms like "excessive speculation," it is in the neutral technical sense. I am not intending to apply any judgmental labels.

These index speculators of course represent managers of pensions, endowments, other investment pools that aren't normally associated with speculation. These money managers are seeking portfolio efficiency by blending noncorrelated productive assets. The .COM bust and the parallel interest in alternative investments led many of them to consider commodities as a portfolio addition.

Regardless of the merits of this approach, there is an overriding practical concern. The commodity markets and the futures exchanges were meant to serve the needs of commodity producers and users, not investors. This marketplace is ill-suited for index speculation.

All this must be understood in the context of how index speculators differ from traditional ones. They are overwhelmingly oriented to the long side of the market, commonly do not deploy leverage and hold positions for long period of time. They add substantial interest to the long side of the market without actually creating much trading volume. In essence, they actually reduce market liquidity.

Part of the problem is relative market size. Index speculators are draining funds from an ocean of traditional investment assets represented by thousands of stock and bond issuers into what are effectively small ponds, about two dozen futures markets.

It is important to note that this impact will only grow. Many institutions have been only testing the waters and are increasing their allocations to the strategy. Institutions that have not yet participated will increasingly follow the lead of others who have. The $260 billion currently allocated by index speculators is only the beginning of a trend. We can reasonably expect the holdings of index speculators to increase more than tenfold and perhaps as much as fifteen-fold.

From a policy perspective we must assess not only the current impact, but the future as well. There are those who claim that index speculators have no real impact on future prices since for every buyer there must be a seller. This misses the point, which is what determines the price at which those two participants meet? Is there any market in the world where the net addition of $260 billion on the long side of the market wouldn't move prices higher? Maybe a lot higher, maybe just a little, but higher nonetheless?

Some concede that futures prices may be impacted by index speculators but claim this has no bearing on the cash market. The mechanisms by which futures prices influence physical prices vary both by commodity and environment. In some cases, there is a clean arbitrage transaction so that a rise in the futures will di-

rectly translate into higher physical prices. Sometimes futures impact cash less directly by providing a reference or index price on which physical transactions are based.

There may be some instances where index speculation indeed influences futures prices disproportionately more than cash prices. However, this is harmful in another way. Commercial users of the futures markets need to rely on predictable relationships between cash and futures. When these relationships break down, commercial participants either flee the market or are forced to bear or pass along additional costs.

In all these considerations, one can argue in good faith whether index speculators create a large or small impact. Those who believe there is eventual minimal influence should consider a future when these index speculators will command far greater assets.

There are numerous proposals before Congress to address these concerns. In my opinion, imposing speculative position limits on both futures and swap desk transactions appears to be the best solution. This would require more transparency in the swap markets than we currently have.

It may be that position limits alone are insufficient to curb the distorting influence of index speculators and some sort of aggregate limitation should be imposed. I don't think this view is currently supported by the evidence, and position limits are an appropriate and productive first step. This would, of course, restrict the use of index speculation as a portfolio strategy. Portfolio managers do have alternative tools for inflation protection and exposure to commodity pricing. Not identical to be sure, but reasonable nonetheless.

Each marketplace has its own rules. Traditional equity and bond managers should be expected to play by the rules of the commodity market when they trade futures, and those rules should and traditionally have included speculative position limits.

Thank you.

[The prepared statement of Mr. Korzenik follows:]

PREPARED STATEMENT OF JEFFREY D. KORZENIK, CHIEF INVESTMENT OFFICER, VC&C CAPITAL ADVISERS, LLC, VITALE, CATURANO & COMPANY, LTD., BOSTON, MA

Thank you, Mr. Chairman and Members of the Committee. My background with commodities and derivatives goes back 22 years. However, I do not believe that my firm or I would benefit or be harmed by the policy changes being considered. I am here because, when I first began examining this issue 6 months ago, I came to the conclusion that this was public policy concern.

The largest drivers of recent commodity price inflation are almost certainly demand growth from developing economies and weakness in the dollar. In the long run, too, markets find their price level based on commercial production, usage, and inventory changes. In short to intermediate periods, however, speculators can be disruptive, influencing prices and hurting consumers. Pension and index investment has become a third force in stoking commodity inflation and damaging the structural integrity of the futures markets. Their activities can fairly be said to represent "excessive speculation."

These new participants—and I'll follow the lead of others—are commonly called "index speculators." When I use this term, and terms like "excessive speculation," it's in a neutral, technical sense; I don't intend these to be judgmental labels. These index speculators represent managers of pensions, endowments, and other investment pools that aren't normally associated with speculation. These money managers are seeking portfolio efficiency by blending non-correlated, productive assets. The .COM bust and the parallel interest in alternative investments led many of them to consider commodities as a portfolio addition. Regardless of the merits of this ap-

proach, there's an overriding practical concern—the commodity markets and the futures exchanges were meant to serve the needs of commodity producers and users, not investors. This marketplace is ill suited for index speculation.

All this must be understood in the context of how index speculators differ from traditional ones. They are overwhelmingly oriented to the long side of the market, commonly do not deploy leverage, and hold positions for long periods of time. They add substantial interest to the long side of the market without actually creating much trading volume. In essence, they actually reduce market liquidity.

Part of the problem is relative market size. Index speculators are draining funds from an ocean of traditional investment assets, represented by thousands of stock and bond issuers, into what are effectively small ponds: two dozen futures markets. It's important to note that this the impact will only grow; many institutions have been only "testing the waters" and are increasing their allocations to this strategy. Institutions that have not yet participated will increasingly follow the lead of others who have. The $260 billion currently allocated by index speculators is only the beginning of a trend. We can reasonably expect the holdings of index speculators to increase more than ten fold, and perhaps as much as 15 fold.[1] From a policy perspective, we must assess not only the current impact, but the future as well.

There are those who claim that index speculators have no real impact on futures prices, since for every buyer there must be a seller. This misses the point, which is, what determines the price at which those two participants meet? Is there any market in the world where the net addition of $260 billion on the long side of the market wouldn't move prices higher? Maybe a lot higher, maybe just a little, but higher nonetheless.

Some concede that futures prices may be impacted by index speculators, but claim this has no bearing on the cash market. The mechanisms by which futures prices influence physical prices vary both by commodity and environment. In some cases, there is a clean arbitrage transaction, so that a rise in the futures will directly translate into higher physical prices. Sometimes, futures impact cash less directly by providing a reference or index price on which physical transactions are based.

There may be some instances where index speculation indeed influences futures prices disproportionately more than cash prices. However, this is harmful in another way. Commercial users of the futures markets need to rely on predictable relationships between cash and futures. When these relationships break down, commercial participants either flee the market or are forced to bear or pass along additional costs.

In all these considerations, one can argue in good faith whether index speculators create a large or a small impact. Those who believe that there is only a minimal influence should consider a future when these index speculators will command far greater assets.

There are numerous proposals before Congress to address these concerns. In my opinion, imposing speculative position limits on both futures and swap desk transactions appears to be the best solution.[2] This would require more transparency in swap markets than we currently have. It may be that position limits alone are insufficient to curb the distorting influence of index speculators, and some sort of aggregate limitation should be imposed. I do not think this view is currently supported by the evidence, and position limits are an appropriate and productive first step.

This would, of course, restrict the use of index speculation as a portfolio strategy. Portfolio managers do have alternative tools for inflation protection and exposure to commodity pricing—not identical to be sure, but reasonable nonetheless.[3] Each marketplace has its own rules. Traditional equity and bond managers should be expected to play by the rules of the commodity market when they trade futures, and those rules should, and traditionally have, included speculative position limits.

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[1] University endowments have led the embrace of alternative investments, with other investors following. According to the latest survey of the National Association of College and University Business Officers, large endowments already allocate 3.6% of assets to "Natural Resources." Using this as a proxy for index speculation, and in light of the approximately $100 trillion global pool of publicly traded stocks and bonds, a potential global allocation of $3.6 trillion can be estimated. A report by the British regulator, FSA, (Growth in Commodity Investment, 3/26/07) infers that a higher percentage may be possible.

[2] Raising speculative margin requirements appears to be a particularly risky policy. For a more thorough review of this, please see the *Appendix*, which includes my article, "Margin Madness," published on MARKETWATCH on June 10, 2008.

[3] TIPS are a well recognized portfolio tool for providing inflation protection. Preliminary research suggests that an equity index like the Morgan Stanley Commodity Related Equity Index offers a strong alternative to index speculation, offering high correlation with commodity rallies, and lower correlation in declines.

APPENDIX

As published on *MarketWatch* on June 10, 2008.

**Margin Madness**

**Commentary: Proposed regulatory cure will only worsen the crisis**

*By Jeffrey D. Korzenik*

Last update: 6:18 a.m. EDT June 10, 2008.

*Jeff Korzenik is Chief Investment Officer at VC&C Capital Advisers, the registered investment advisory of Vitale, Caturano & Company Ltd., a Boston-based wealth management, accounting, and business services firm.*

**BOSTON (MarketWatch)—Last Friday's startling spike in oil prices has refocused attention on the role of futures speculators in driving inflation. Higher energy prices are likely to renew calls to raise margin requirements for speculators in an effort to moderate prices.**

Those calling for this approach have misdiagnosed the problem and prescribed the wrong cure. Higher speculative margin requirements could well result in higher prices and the further decay of the structural integrity of the futures markets.

Unfortunately for consumers and for concerned policy makers, there's no "quick fix" that strengthens the dollar or increases oil production to meet demand from the developing world. Policymakers instead are focusing on the role of noncommercial participants in the commodity futures markets. Much has been made of the supposed role played by "speculators," but this term no longer adequately describes the full breadth of noncommercial participation in today's market.

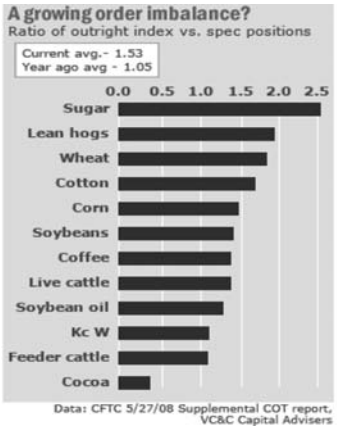
There are indeed still speculators of the traditional variety—highly leveraged players who play both the long and short side of the market and move quickly in and out of positions. However, today's commodity futures activity is marked by the presence of a new type of noncommercial participant. These new players treat commodity futures as an investment asset class, and they represent some of the largest pension funds and asset managers in the country.

These "commodity investors" behave very differently from the speculators. They are overwhelmingly oriented to the long-side of the market, commonly do not deploy leverage, and hold positions for long periods of time. Policy makers seeking to moderate commodity prices need to distinguish between speculators and these new commodity investors.

There has been a recent debate about the impact of these commodity investors. There is a strong argument to be made that these new investors both push commodity prices higher and disrupt the market. Unfortunately, some of the debate has been informed more by sentiment than by fact—after all, we instinctively think of "investment" as good and "speculation" as bad. In the futures world, the opposite is true. Speculators, with their high levels of margin and short-term trading, create a tremendous amount of volume with a limited amount of capital, ensuring critical market liquidity. Investors, on the other hand, provide little benefit to the futures world, and lots of problems.

The commodity markets operated quite efficiently without "investors," who have only entered the arena in any size within the last few years. The introduction of roughly $260 billion dollars of long-only investment has effectively created an order imbalance—futures prices have had to move higher to draw out opposing short interest. The capital pools upon which the investors draw upon are quite deep. In contrast, traditional speculators have limited trading capital. Commercial participants are constrained by both the size of their working business capital and by the amount of physical commodity they can control. The capital committed to commodity investors is large and growing, and if current trends continue unchecked, it could grow to several trillion dollars.

Much has been made of the investors' position size relative to the physical marketplace, but it is also worth considering the size of the investor commitments relative to the speculator commitments. The chart below illustrates data from the




CFTC's supplemental Commitment of Traders report which includes indexed investor positions for select marketplaces.

The graph compares outright market positions (i.e., spread trades are excluded) of the speculators, both long and short, to those of the investors, and displays the ratio between the two. While an inexact measure, this ratio suggests the relative "firepower" of the investors *versus* the speculators.

On average, the investor positions outnumber the speculator positions by 1.53:1. When one considers that the investors are virtually only found on the long side of the market, it is clear that this is not a match of equals, hence the order imbalance which puts upward pressure on prices. Moreover, the ratio is trending higher, having been as low as 1.05:1 just a year ago—if this is indeed an order imbalance problem, it is getting worse.

How does demand for futures contracts impact prices in the physical markets? Because the investors do not take physical delivery of the commodities, many have been too quick to dismiss their profound impact. While it is true that over the very long term, physical supply and demand will determine the outcome, futures investors are an inflationary force in shorter time frames. This is particularly true of markets like energy, where neither supply nor demand is very responsive in the short term to higher prices.

There are three mechanisms by which the order imbalance created by commodity futures investors can drive prices higher in the physical market:

1. Higher futures prices directly impact those who contract to buy or sell on a forward basis (*e.g.,* airlines which contract for future fuel needs, either directly through futures hedging or through physical sellers who price on the basis of the futures market).

2. When futures prices are bid up independent of the physical market, this stimulates an arbitrage trade, where cash goods are purchased and futures are sold, locking in price differentials but driving up cash prices

3. The imbalance within the futures markets disrupts traditional cash/futures relationships which ultimately adds risk, uncertainty and cost along the commodity supply chain. This is ultimately reflected in higher prices to the consumer.

In addition to these direct influences, there is also a case to be made that the higher futures prices support an inflationary psychology. We all face the bombardment of news of higher prices in energy, food and precious metals. It may be that this increases the willingness of commodity users to pay higher prices, and of commodity users to demand increases as well.

What would happen if the regulators chose to raise speculative margin requirements? How would this impact the order imbalance caused by the investors' capital? The answer is unequivocal—higher speculative margin would increase rather than decrease commodity prices. Higher margin would decrease the ability of traditional two-sided speculators to establish positions, and would not impact the long-only, unleveraged commodity investors. This would increase the ratio of commodity investors to traditional speculators. To the degree this order imbalance is causing higher commodity prices, it would only get worse.

Policymakers would be well advised to consider other tools at their disposal. At the end of the day, commodity investors are using the futures markets in a way that they have never been used before—and for which they are ill-suited. It is a legitimate question of public policy whether this should be constrained or even permitted. The investment community, too, should reconsider the legitimacy of consumable goods as a core asset class. After all, the last time we considered an agricultural good a great investment, the commodity was tulips.

The CHAIRMAN. Thank you. We maybe don't have all of the right people on this panel for this question, but I have been asking this question. I still haven't gotten an answer that has gotten through my head anyway; that is, as I understand these index funds, that

is some kind of an instrument or security actually that is created and is priced off of the index or off of the futures market. And, people buy these things and the money does not go into the futures market. Money goes to whoever sold them this instrument, right? And it does not at that point go into the market and these indexes are never going to buy these commodities. Am I right so far?

Mr. KORZENIK. If I may, sir. There are various vehicles and various ways. The most basic would be, something like a gold exchange traded fund. This was the first of these publicly traded vehicles to gain a lot of attention. And it actually bought physical bullion. To give you a sense of the power of this investment capital flowing in, it currently holds more gold than the reserves in the European Central Bank. But some of the others will go into the futures markets. Some of the others will effectively participate through swap desks, who in turn are laying off their risk even——

The CHAIRMAN. That is the point I was getting to. But, I mean, by and large, though, like in oil, most of these are not going into the futures market and buying those positions in the futures market.

Mr. KORZENIK. Some are going in via swap desks.

The CHAIRMAN. So, then, whoever sold this investment, they are going to lay their risk off someplace. And as I understand it, generally it is in the over-the-counter market that they go into and find somebody to take the other side, some bank, Merrill Lynch or whoever. The only thing that actually goes over into the futures market is whatever they cannot net out. Am I wrong about that?

Mr. KORZENIK. You are correct on the mechanics, sir. But following the weak point of that argument——

The CHAIRMAN. It is not an argument. I am just trying to understand.

Mr. KORZENIK. I understand, sir. But there are those who are arguing that because the swap desk transactions are essentially balanced they don't have an impact on the marketplace. That is another way of saying, and this is a falsehood, that there is no price impact because there is a seller for every buyer. The issue at hand is if these transactions are being executed through a swap desk and you have physical sellers of oil and you have an index speculator on the long side, the question is what would happen if the index speculator was not there. That short seller or the swap desk would execute the short transaction that laid off their risk through the futures market and without the index speculator there. Of course the index speculator could go in through the futures, or if that money was not there, the short hedger would have to sell down to a price to attract buying interest and long interest. So it really washes through. The argument that what happens on the swap desk if it is balanced doesn't matter is really saying that aggregate demand doesn't matter, it depends where that demand is. And I believe that is not correct. Aggregate demand is what is important.

The CHAIRMAN. I don't understand where the demand is coming from because this money that has paid for this index goes to the investment bank, not to the market and not to the oil seller, right?

Mr. KORZENIK. Ultimately it represents a long interest in the market.

The CHAIRMAN. Well, a fictitious long interest that they have created. It is not a real long interest. It is just something they created and it is kind of like a casino that is based on some deal that is going on over here and you are going to say, "Okay, we are going to make a deal or we are going to use this and I am going to bet this way, you are going to bet that way, and we are going to see who wins."

Mr. KORZENIK. Pardon me. Some of the references to gambling and casino have some application to the futures markets. But at the heart of the markets, these are contractual obligations. It is not like saying at the roulette wheel where your wager doesn't influence the roll of the wheel. These too have influences. And what essentially happens is the index longs crowd out the commercial longs. There are long hedgers as well and they essentially get crowded out by this, which has an upward pressure on price.

The CHAIRMAN. So I still am not tracking this because these long hedgers that are getting crowded out, how are they getting crowded out, out of where? Out of the futures market?

Mr. KORZENIK. If there is on a swap desk—if there is a short hedger——

The CHAIRMAN. You are talking within the swap operation?

Mr. KORZENIK. There is some customization of the marketplace. But, as Dr. Pirrong mentioned, there are also things that keep the prices aligned to some degree in these markets. On a look at it purely from the commercials, you have commercial longs and you have commercial shorts. They have to come together somewhere. If you add in new commercial longs, whether they are commercial or they are index, there is an upward pressure on where those transactions occur.

The previous panel had this umbrella analogy. Think of a seller of an umbrella that someone else wants to buy. Add in five new buyers who are really aggressive. That is going to increase the price of that umbrella, to use the previous panel's analogy.

Dr. IRWIN. Mr. Chairman, maybe I can add a couple of facts that may be helpful in this situation. In terms of the netting of their laying off of risk, we do have some good data already on the volume of that activity in our commodity futures markets through the CFTC's commodity index trader reports. That gives us some very useful market statistics already. Recently, the index trader positions as a percent of open interest are basically in the range of 10 to 25 percent of total market open interest. That certainly is a change in the structure of the markets. But it simply isn't any evidence that they are overwhelming our commodity futures markets, and I would also point out that there is a logical fallacy that seems to be committed here. There is no limit to the number of futures contracts that can be created, in the sense that you can't crowd out someone else in a futures market because you can create an infinite number of futures contract if you wanted. It is like you said, you can create as many side bets as you want.

And the other interesting part of that point is our grain futures market. I know it is very important in your district. In fact the biggest change over the last 2 years in the structure of open interest has been the extreme surge in short open interest by commercials, the people that are taking the other side of the positions from long

only index funds. For a transaction to occur, it is voluntary, you only have a transaction if the short and the long can agree on a price given available information. That is what has been going on.

The CHAIRMAN. The one thing about these index funds is that they are being driven by a formula. I don't think they look at what the price is. They are just wanting to get into the market, right? I mean, they have decided that they can't make any money in any other place, and so this is where they are going to go. They have made good returns the last few years. I think somebody is going to lose their shirt frankly at some point, and I have a real problem personally with pension money, I am sorry ma'am, being put in these commodity funds. I think that is a bad idea. As someone who used to be Chairman of the Pension Commission for the State of Minnesota, I know a little bit about that because when this thing unravels, there are going to be some unhappy folks. We don't have control over that. So you don't have to worry.

Ms. DIAMONTE. Mr. Chairman, as you know, I am the CIO for United Technologies. We don't have any direct investments in commodities at all. But representing CIEBA, as I mentioned, on looking at our survey for 2007, which manages $1.5 trillion combined with natural resources and commodities, there is less than one percent investing in this.

The CHAIRMAN. I understand that.

Ms. DIAMONTE. It is not a large percentage.

The CHAIRMAN. I know. I looked at that. But, personally, that is one percent too much. And if you aren't invested, I commend you. I think that is a good decision. And I know that some of these pensions that are in for one percent are now looking to put in more. And I know how this works. They all go to these meetings and they talk to each other about where they are making money. And I will guarantee you that this is going to go up. And how far it will go, I don't know. But, I am not sure that you want to put people's pension money in something as volatile as the commodity market.

Ms. DIAMONTE. Mr. Chairman, there is a lot of study that has been done over time and it depends on the end period of whether commodities actually add value. A commodity is a commodity. So is it really a valuable asset class that is going to add return? But one fact is that it is extremely uncorrelated with the stock market and uncorrelated with the bond market. And for many pension plans who have liabilities that are gauged to inflation for the benefits, commodities moves with inflation.

The CHAIRMAN. I know what drives them.

Ms. DIAMONTE. There are a lot of valid reasons why some of my colleagues are investing in them.

The CHAIRMAN. I know. And it might have been legislators or whatever that put these benefits in that can't be sustained and so these managers have to scramble around trying to figure out how to pay for it because they have unfunded liabilities. I understand all of that. And I sympathize with them, but I am not sure this is a good strategy in the long term.

Mr. CICIO. Mr. Chairman, you pointed out a very important thing. Index funds generally don't care what the price of the underlying commodity is, and that is a problem for commodity markets. It may not be a problem for stock markets, bond markets, I don't

know. But for commodity markets, it is different, it is about a physical delivery of a product. And that product needs to reflect underlying value. What is really important to a producer of, let's say, natural gas, they don't want the price to be too low to ensure that they have a profit to produce more. They don't want the price to be too high because then they get demand destruction and they lose markets.

For us consumers, we care a great deal because we don't want the price to be too low so that the producer can't continue to produce it. But at the same time, it can't be too high that it drives us out of the market and we are not competitive. We care. The basic hedgers, the physical hedgers, have skin in the game and hedgers and index funds do not.

The CHAIRMAN. Mr. Neugebauer.

Mr. NEUGEBAUER. Ms. Diamonte, as a manager, I assume your responsibility is to manage a pension fund; is that correct?

Ms. DIAMONTE. Yes, it is.

Mr. NEUGEBAUER. And so when you look at return, the people that are depending on your investments are looking for an after-inflation return on their investment?

Ms. DIAMONTE. You know, I really think it depends on the plan sponsor. As you know, many corporations have different expected returns, and many of them have different benefit designs. And there are some corporations that have put cost-of-living adjustments into retirement benefits, so they are tied to trying to get inflation numbers. There are others that don't, are not being raised by inflation, and therefore don't worry about that hedge.

Mr. NEUGEBAUER. It might not be important to the companies, but it is certainly important to the retirees; is that correct?

Ms. DIAMONTE. Absolutely.

Mr. NEUGEBAUER. And so what is, in your opinion, one of the best hedges against fairly rapid inflation that we are having right now?

Ms. DIAMONTE. Well, studies show that there are very few asset classes that actually are highly correlated with inflation. In other words, as they increase, gain prices increase. Commodities is one of them; real estate is another one, and we all know what the valuation is in the real estate market. So it is very hard for pension funds like ourselves to try to invest in assets that actually are very correlated. Treasury index inflation bonds is another one. The prices of that have actually been low, so it is difficult to actually get good inflation hedges.

Mr. NEUGEBAUER. But it is important to.

Ms. DIAMONTE. It is extremely important.

Mr. NEUGEBAUER. So really one of the things that has happened in our economy right now is we have had a huge decline in our dollar, which has caused huge inflationary pressures, and particularly it has caused a tremendous decrease in the value of investment for companies that are holding dollars because the dollar has obviously gotten weaker. Should we prohibit people from being able to look for opportunities to hedge or to protect themselves from these inflationary times?

Ms. DIAMONTE. I think it is our opinion that we really need to adhere to good portfolio modern theory, which means that you need

to look through all the different markets and find the best asset-allocation policy that meets your long-term liability needs. So I would say no, not to prohibit in any asset class. And we have many opportunities to invest internationally on an unhedged basis, so if the dollar does go down, we still can maintain some of that return.

Mr. NEUGEBAUER. Now, I tell you what. This panel, with the exception of one, has got the name thing a little tricky here. I wasn't here for the introductions, but is it Mr. Cicio?

Mr. CICIO. Yes.

Mr. NEUGEBAUER. You seem to be advocating that we should only let people that have skin in the game be in the marketplace. And so I think one of the things that we have had a difficult time here is who are people that have skin in the game?

For example, in my former life I was a land developer, and in the land development business, I used a lot of plastic pipe that is oil based. The asphalt that I was purchasing in large quantities was oil based. The diesel that was being used to do the excavation and all of the operations necessary to put in that infrastructure was oil based. And so under the current scenario that I hear some of the testimony, I would be a speculator. When, in fact, I might have been trying to hedge a business position because of the tremendous amount of intensity that my business relied on oil-based products. So are you going to throw me out?

Mr. CICIO. Absolutely not. It sounds to me like what you described is someone that is a business person who has a real hedge opportunity. You are doing something in relationship to your business that is associated with the underlying commodity. That is who should be playing in these markets, as I contrast that to index funds, who, as I say, they don't care what the price is. They are just throwing mounds of money into it, and they have a different intent, a different strategy than historical participants, buyers and sellers for a physical future delivered product.

We need speculators in these commodity markets. Don't misunderstand what I am saying. I pointed out earlier everything worked pretty well in these futures markets prior to the year 2000, prior to when we made changes to the Commodity Futures Modernization Act. And that opened up the door to a lot of increased speculation that now has picked up steam and is rapidly accelerating for players that, as I say, don't have skin in the game.

Mr. NEUGEBAUER. I believe if I called up today and tried to take a position to hedge in a futures contract, I would not be a qualified hedger. I would be a speculator. I would like to hear someone that knows a business in America today that is not being impacted by higher energy prices.

Now, the other thing is that I don't have the expertise to sit and trade hedges all day long. When I was in the land development business, I needed to be out selling things, because there is an old philosophy in my business that if you don't sell anything, you don't get to eat. And most of my family did like to eat, so I needed to spend more of my time trying to sell something.

So one of the things that some of these investment vehicles provide an opportunity is for businesses that don't want to be involved in trading and don't want to have to make a margin call, if the market is swinging. My final question is that the term "excessive

speculation" keeps being kicked around here. What happens is about every 6 months we come up with buzzwords in Congress, and so the buzzword *du jour* right now is "excessive speculation," that it is somehow ruining the world. What is "excessive speculation?"

Mr. CICIO. Well, for natural gas I will tell you that when the analysis we just did, the volume of natural gas is trading in the neighborhood of 24 to 32 times the physical consumption of, let's say, the August natural gas physical commodity. We don't know what the right number is where excessive begins and ends, but we look at 24 times and 32 times and say, "That sounds like excessive speculation to us."

Mr. NEUGEBAUER. Anybody else want a bite at that apple?

Dr. PIRRONG. Essentially the key thing, is that that demand is not translating into the physical demand that is affecting the price that Mr. Cicio and his clientele are worried about. Essentially if you look at deliveries, for example, they are a trivial fraction of the kinds of volumes that he is talking about here. And in terms of the swimming pool analogy, well, to be quite honest, these index funds and everybody else are well out of the pool by the time that these contracts go to delivery. So these folks are not contributing the kind of physical demand that would be causing prices to move away from where they should be.

Dr. IRWIN. I think you raise an excellent point that in our history of the regulation of commodity futures market, we have struggled from the beginning in the 1920s, when we first decided that we needed to have regulation regulating the level of positions in the markets. That means we needed to define what was a hedger, and that has been a difficult debate now running over 80 years.

For example, at the University of Illinois right now, in responding to the farmers that we talked to, one of their biggest concerns is rapidly rising production costs. Anybody that is working with farmers knows that it, particularly fertilizer, is skyrocketing. Our research shows that the item that has most positively correlated with the increases in the price of their cost of production is crude oil. So if they are to hedge their input cost increases, it would be a very reasonable thing for a farmer to do today. I want to protect myself from that. What can they do? They need to buy something that is very highly correlated with the movement of the crude oil. And even though that is very important to their business, that would be classified as a speculative move.

Mr. NEUGEBAUER. Speculative, exactly. Every businessman, unless he is taking delivery of hydrocarbon in a bulk sense, would be classified as a speculator.

Dr. IRWIN. It is in fact, actually quite difficult to precisely define who is a hedger and who is a speculator. And we have been trying to slice that for 80 years, I think fairly unsuccessfully.

Mr. NEUGEBAUER. One of the last points I want to make, and someone can pick up on that, is that I am told in the last few years, that for a long time the major oil companies did not really deal in the commodities markets. They were producing, but they were not doing as much hedging as a number of them are today. I would like to get your reflections. What I am told is because these price levels and the cost levels of going after some of these deepwater drilling and some of the deep natural gas wells that are

now—that cost millions and millions of dollars, that these folks have gone into a much more aggressive risk management process. And so when we look at some of these volume increases over what the volumes were 10 years ago, what the volumes are today, is that it is just that people are trying to use the commodity market for what they were designed to do, and that is to protect those folks.

Mr. CICIO. That is one of the things that gives us great concern is if you look at the forward curve of any of these energy commodities, most of the volume is in the front month. And what we need are speculators, buyers and sellers in those future months. So the market could be working better, but instead we have—as I will go back to this issue of the index funds, it is all in the prompt month, and it is rolled over to the next month. So you have this huge mound of money that keeps getting bigger and gets rolled over, sold, rolled over to the next month and then the next month, and we just have this fundamental belief that if you keep throwing money at a commodity, certainly that mound of money, it certainly is going to have an impact and a speculating effect.

The CHAIRMAN. I thank the gentleman.

The gentleman from California. Do you have any questions?

The gentleman from North Dakota.

Mr. POMEROY. I want to thank the panel. It has been absolutely excellent, really very, very interesting. Thoroughly knowledgeable experts reaching very different conclusions. And so it is a little puzzling up here, but it certainly is fascinating.

Dr. Irwin, you are clearly an expert and exponent of market function. And so experts like you have helped me understand the relationship of liquidity in terms of futures speculation, in terms of easing price fluctuation, volatility in the marketplace. Do you get to a point where you have so much money coming in, where the market is so hyper-liquid, that the legitimate price discovery function of the market can be disrupted?

Dr. IRWIN. My view is that, yes, that is theoretically possible. We have to, as economists, admit that it is possible for a futures market in commodities to become overspeculated. The difficulty, of course, is then figuring out where that line is and how do you determine what is—when it is too much.

In research that I have recently completed looking for the kind of standards, what we did is we looked at the relative levels of short hedging in these markets *versus* long speculation, where the index funds would be located. And, in fact, we find that the levels of commercial hedging seem to be pretty similar to what we had seen many, many years ago. In fact, they are very similar to what we saw going all the way back to the late 1940s and into the 1950s. So the markets, as best we can tell, based on historical standards, do not seem out of balance. But again, I admit that it is possible.

Mr. POMEROY. I am coming back to you.

Mr. KORZENIK. If I may. I think one of the issues here, and Dr. Irwin is quite right, is this theoretical overspeculated marketplace. And I guess where I would disagree with him is, as an academic construct, you can make more and more future contracts. You have plenty of people to adjust for price discrepancies. But, particularly in some of the smaller markets is where you would start to see the problems first. And if you look back and say, what happened to cot-

ton in late February or early March, and I know there is an ongoing CFTC investigation to this, but you start to wonder whether we are running up against some of the limits.

So, for instance, there are only so many short hedgers out there. There is only so much product that can be short-hedged, let alone the much smaller amount that is actually deliverable into the contracts. And then speculative shorts, longs and shorts are also limited by capital constraints. So, yes, ultimately you can draw more in over time, perhaps.

Mr. POMEROY. Would the fact that the Farm Program pays for cotton storage have a—potentially a complicating factor here?

Mr. KORZENIK. Yes, because anything is a change, a disruption from total free market.

Mr. POMEROY. It takes out some of the incentive to sell.

Mr. KORZENIK. You know——

Mr. POMEROY. That is really a matter for another day.

Dr. Irwin, you indicate that if indeed price becomes separated from the fundamentals of supply and demand, that this arbitrage incentivizes the profit taking and rationalizing the market. Is that what you are saying?

Dr. IRWIN. Correct. That, as Dr. Pirrong talked about this morning, that in the real physical market, if you are creating a bubble, and again you are creating it against other well-financed, large, very smart, very good traders, somewhere, someplace, somebody is going to then be holding the commodity off the market, and that should be evident.

Mr. POMEROY. Right. I am almost out of time.

Mr. Cicio, why don't you think that is working?

Mr. CICIO. Would you repeat the question?

Mr. POMEROY. Sure. Basically the profit-taking opportunities, if pricing becomes diverted from rational pricing based on supply and demand. Essentially Dr. Irwin has talked about the way the market corrects when trading creates a situation where the pricing may not accurately reflect an economically rational price based on supply and demand.

Mr. CICIO. Well, that is just it. When you have, as I said, new players in the market, and index funds are relatively new players, that don't care about the price, they are just throwing money in, it just changes how that price is going to come out the end. It just does.

Mr. POMEROY. Dr. Pirrong, do you have a 30 second answer to that?

Dr. PIRRONG. Just to add to what Mr. Neugebauer said, which was, "Hey, we have all these oil companies out there. They have huge capital. They have huge information. If they really thought that the price of oil would be driven up to excessive levels as a result of this index speculation, that would be a great opportunity for them to make money. And they have the financial wherewithal to do that."

And again, also it is important to make the distinction between the physical market on the one hand and the financial market on the other hand. These players are out of the game. They have cashed in their chips by the time this market goes physical, so they are not contributing to the demand for that product.

Mr. POMEROY. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Mississippi, do you have any questions?

Mr. CHILDERS. Mr. Chairman, for the sake of time, I do not have any questions.

The CHAIRMAN. Thank you very much.

The gentleman from North Carolina, and then we have a vote here. We are going to take these questions, but we are going to come back. Mr. Marshall has some questions of this panel, and I may have some more, if that is okay. Thank you.

We have about 8 minutes. So we have time for your questions, I think.

Mr. ETHERIDGE. Thank you, Mr. Chairman. And, Mr. Chairman, at the appropriate time I am going to have a couple of letters I would like to submit for the record.

[The documents referred to are located on page 261.]

The CHAIRMAN. Without objection.

Mr. ETHERIDGE. Because they are the real, live folks, people who are major corporations now on the verge of going out of business because of the commodity and fuel prices.

So my question goes back, very quickly, Ms. Diamonte, I believe it is, how long have your folks been investing pension and retirement funds in the commodities markets? Do you know? When did that start?

Ms. DIAMONTE. CIEBA as a whole? I don't know the answer to that.

Mr. ETHERIDGE. Can you get that for us?

Ms. DIAMONTE. Sure. We have been collecting data for over 15 years, so I could show you the trend of that over time.

Mr. ETHERIDGE. Maybe some graph as to when that increased.

Thank you, ma'am. I think that is important because I think some of these are critical pieces. The letters I am going to submit are letters that are real life view of people's lives. They have lost a lot of jobs as a result of it.

Mr. Cicio, you asked that we ensure that the Federal Reserve is not loaning capital at low interest rates to banks which turn around and speculate those funds in futures markets. And you also state in your testimony that you don't believe that the almost linear relationship between lower Federal Reserve interest rates, increased borrowing of banks and corresponding higher commodity prices is a coincidence.

I would be interested in hearing you comment more on that because I really thought the Federal Reserve checked to see how loans it offered to banks are being utilized. And if not, we sure need to have our corresponding work with that. And I guess I want to know do you think the Feds are monitoring? If they aren't, why shouldn't they be doing it? That is a serious problem if it is true.

Mr. CICIO. Thank you.

We do not know if the banks who are borrowing Federal Reserve money are speculating with it. We could not help, though, when we saw the correlation of the timing of the lower interest rates to the significant ramp-up of borrowing by the banks and the relative correlation to the escalation of energy commodity prices and commodities in general. And so we are not accusing the banks of anything

or the Federal Reserve of anything. We are just raising the question.

Mr. ETHERIDGE. Do you have any data on that?

Mr. CICIO. Well, we have more charts like the ones that were in my testimony that showed these relationships. That is all we have.

Mr. ETHERIDGE. Would you make those available to this Committee?

Mr. CICIO. Yes, sir.

[The documents referred to are located on page 262.]

The CHAIRMAN. Will the gentleman yield?

Mr. ETHERIDGE. I yield.

The CHAIRMAN. When we cut the interest rates, I think people expected the dollar to fall and potentially inflation to take up. So weren't they just then shifting over, understanding that this is a foolhardy policy probably, and they are going to make use of it? I mean, the dollar has fallen how much since then, and as I understand it, that is why a lot of people are going into this market.

Mr. KORZENIK. If I may, Mr. Chairman, there are a number of theories relating to interest rates and commodity storage and things like that. But a lot has been talked about the role of the dollar, and there is no doubt that the dollar has had a role. But there are other things at work.

For example, the dollar since mid-March has essentially been trading sideways, yet oil prices, crude oil prices, are up 35, 40 percent since that time period. So one of the challenges in trying to examine this whole index speculation issue or speculation issues is you can analyze, you can guess, but you can never know with certainty what fully causes a price move.

So there is certainly a role of the dollar. I don't think anyone denies that. But I would argue that there are other factors at work as well. In fact, the very close correlation between the dollar and crude oil, for instance, during last year was almost too close. Oil is not necessarily a currency, and you had an almost exact correlation, which is unlike previous periods. So if you go back 20, 30 years, the correlation between commodities and the dollar is much, much weaker than one would be led to believe by the press. It is certainly a factor. I wouldn't deny that. I just think you shouldn't walk away saying, oh, it is the dollar and nothing else, and not look at these factors.

Mr. ETHERIDGE. Let me get one final question in. Professor Pirrong, on the following panel and in the written testimony, Mr. White alleges that $167 billion in new inflows have gone into the 25 commodities that make up the major indexes. Have you seen this analysis?

Dr. PIRRONG. Not that particular analysis, but I have seen similar figures, yes.

Mr. ETHERIDGE. I would be interested in your thoughts on that, and also, if you believe these can be substantiated? I think this Committee needs to have some basis for that. If you don't, I would be interested in your thoughts on it.

Dr. PIRRONG. Well, I have a couple of thoughts. First of all, I mean, is this a bug or a feature, right? I think that is essentially what we are asking; is this a good thing or a bad thing? And in terms of the ultimate question, you have quite eloquently talked

about your concern about what effect this is having on real people and what they are doing. And to be quite honest with you, sir, I don't really think that it is causing the pain that your constituents and other folks' constituents are suffering.

Mr. ETHERIDGE. So what do you think is causing that pain?

Dr. PIRRONG. Oh. We have how many minutes before your vote? I don't think we have enough time. But in a nutshell, in some respects a perfect storm in terms of perverse policies, particularly among developing nations that are subsidizing consumption at the same time when political unrest and essentially the harvest of lack of investment over the last 10 years has really put a cap on supply. Add that with a little gasoline on the fire from the Federal Reserve and we have a very difficult problem.

The CHAIRMAN. Well, thank you very much.

The Committee is in recess. We will take this up when we get back.

[Recess.]

Mr. MARSHALL [presiding.] If everybody can take their seats. Chairman Peterson has asked that I reconvene the meeting, and I guess we should do that in the interest of diminishing the amount of time that you are stuck here and moving this thing along. And as it happens, I am the next person to ask questions anyway.

Is Dr. Pirrong—here he is. Okay.

Before the Chairman adjourned so quickly, I was going to try and intervene, lost my opportunity to do so. And had I had an opportunity to do so, I was going to ask that the two good doctors here, Irwin and Pirrong, get together with Mr. Korzenik and the three of you agree on the nub of your difference of opinion so that we can get right down to where it is that you differ.

And it may be it is this burden of proof stuff that a number of people have suggested to us. Nobody can really prove their case, so cast the burden on the side of the other, and that decides the matter.

And so if you guys could give that thought, let me ask Dr. Irwin a question. In a follow-up to a response, you said that you thought that there was some evidence out there that this largely passive long index fund money that is coming in simply because it wishes to take a position isn't influencing the market all that much. And you cited two things, and I just wanted to explore those two things. One, I think you said there was 10 to 25 percent open interest by commodity index funds, which is a relatively small thing, not overwhelming, is the way that you put it, so it couldn't possibly be overwhelming the market.

And then the second thing that you said was that as you look at who is long and who is short, the index funds seem to be long, but the commercials are short. Did I understand you correctly?

Dr. IRWIN. Yes, that is correct.

Mr. MARSHALL. And when you say commercials are short, you are referring to people who actually have an interest in the industry, they have oil to sell or something like that?

Dr. IRWIN. Correct. And these were producers, processors. And I am no expert here by any means. And you see all of us sort of fumbling around trying to grasp what is pretty arcane and complicated stuff, trying to just figure out what is the right thing to do to try

to help folks out where these prices are concerned and at the same time not ruin these markets or drive business overseas. It is a delicate balance that we need to strike here.

Mr. MARSHALL. And when you cited as support for this commodity money and long positions not being much of an influence. The second point, I found myself wondering, and I may be missing something altogether here, if it might not be an argument for exactly the opposite conclusion or evidence to support exactly the opposite conclusion. When what you are saying is that the commercial side, the folks that are typically in here for business reasons are on the short side and the folks that are in there, intending to take a position and hold long, but are not in there for typical commercial physical market reasons are on the long side, doesn't that suggest that those who are in the business normally think prices should be a little bit less and they are willing to take the short position because they see these prices and they think, "Good gosh, that is a better deal than I think the market would normally give me. And so, yes, I guess I am going to take that deal." And one after the other I guess they are enticed to take that deal, to go ahead and agree to sell at some later date at a certain price. They are inclined to do that as the price gets pulled higher and higher and higher by what you describe as "open commodity long positions," folks who don't have a commercial interest.

Could you set me straight? I am confused.

Dr. IRWIN. It is an excellent question. I want to make sure I am understanding your point that you are talking about. The point I made was that the relative balance between the hedging interests in the market, at least in agriculture and many other markets, tend to be on the shorter selling side, that that is not out of balance relative to the long speculation in the market, which is where the long index funds——

Mr. MARSHALL. We have had lots of testimony that in order for you to have a contract, people have to come together. So the question is, at what price do they come together? And if the commercials are saying, geez for that price I will sell either side and the—what we are sort of focusing on as the current crowd of speculators as opposed to the experienced ones who have been providing liquidity for a long time and you typically find on either side. I am going to go short this time, I am going to go long next time, that sort of thing, those kind of speculators have been in the market for a long time. We want them in the market, they help provide liquidity, they narrow the margins, they enable hedges that otherwise wouldn't be available for the commercial side. Now we have a whole bunch of money in the market that is just going long and it sounds like this long money in the market, people want to take positions because they want to be in commodities. You have the commercials on the short side, them on the long side. It sounds to me like that the commercials are going, "Golly, if you will pay that much for it, I will do it because I am not going to get that kind of money from anybody else." And if that is the case, isn't that evidence that the longs, in fact, are pulling the market up as opposed to evidence, as you suggested, evidence that no, they are not having any impact?

Dr. IRWIN. Okay. What I would say in response to that is that what we know from at least historical patterns in commodity futures markets is that hedging, in essence, speculative volume tends to follow hedging volume. That pattern has been established for many, many years. Yes, you are correct. That could be changing. This is a new type of trader. So it does raise the kind of questions that you are raising. But it would be different than the traditional pattern of the speculation following the hedgers' volume and that is why the balance doesn't seem out of balance.

The next response I would have is that we have to be careful that anyone with a short position at that point in time generally will have a view that prices are attractive to be a seller. So as price goes up, there are always going to be a concern, particularly if they are wrong. And that is a story we know about as it has happened in agriculture a number of times.

Mr. MARSHALL. Can I interrupt? I am just trying to get you to get to the nub of my question. It is a question, it is a concern. I don't know. I am not an expert here. Hypothetically, let us assume that there are, I know this isn't the case, but let us assume that everybody who is short, are commercial types that have historically been in the market for a long time. And everybody who is long, are newbies, they are the commodities, the index funds, *et cetera.* Let us hypothetically assume that is the case. Would you say that is evidence that, and let us also assume that prices are going up. I mean, we are observing that. Would you say that is evidence that something must be going on, that these longs, that this new money in the market, different from the historical money in recent years, anyway, that it must be pulling things up? Would you say that is the case?

Dr. IRWIN. I don't believe, no, that is sufficient evidence.

Mr. MARSHALL. If all the commercials are on one side and all the investment folks are on the other side?

Dr. IRWIN. No, because they could all be reacting to the same common information about underlying supply and demand.

Mr. MARSHALL. Dr. Pirrong, if you could weigh in on that. Let us hypothetically say that is the case. And all the commercial folks are saying, "There is no commercial person out there saying I want to buy at those kinds of prices," but there are a lot of commercial folks out there saying, "Hell, yes, I will sell at those kind of prices." And they are the ones that are traditionally in the market and the ones that largely are the folks that are speculators that are traditionally in the market and are also on the short side and going, "Whoa, heck, yes." And then on the long side is all this passive, not as experienced money. Let us say, hypothetically, that is the case. Would you say that prices are being pulled up by this passive, not very experienced money?

Dr. PIRRONG. Not necessarily. And here this might be a little inside baseball. But I think it is important to draw a distinction again between the physical market on the one hand and the financial market on the other hand. Essentially what economic theory tells us is that speculative participation is primarily going to affect the futures price relative to what the spot price is expected to be when that contract reaches delivery. And essentially the difference between those two things, the futures price on the one hand and

the expected spot price on the other is a risk premium. A risk premium is a cost to the hedgers and essentially what can happen is you can have a situation where the following is true. We have a flow of new speculative money into the market that reduces the risk premium, which if commercials are net short would tend to cause the futures price to rise relative to the expected spot price. That doesn't mean that the spot price, the price for what barrels, in the case of oil, is being distorted or is too high and it actually means that actually that increase——

Mr. MARSHALL. Doctor, it is hard for me to follow you and you are trying to help me. So let me interrupt you and just ask you this. You earlier had said that all these folks talked to one another. I mean there is a rule here in politics, if three people know it, it is no longer a secret. It is inconceivable to me that somehow the physical market and the financial market, the speculators around the globe, *et cetera,* just don't know what everybody else is doing. So even though it is in what we refer to as opaque, dark markets, there are an awful lot of people playing who are playing in the futures market, which is transparent to us and regulated by us, that know absolutely what is going on in the dark markets; and folks in the dark markets of course know what is going on in the others. And it is very unlikely that there is some arbitrage to be had because people are so stupid that they don't have information; isn't that correct?

Dr. PIRRONG. Yes, that is actually what I said earlier. There would be information flow between these markets, yes.

Mr. MARSHALL. So what I don't understand is how all of the people who are historically savvy and commercially involved in my hypothetical could be on the short side and you wouldn't conclude that this group on the long side, either because they know something everybody else doesn't know, or they are in it for a different reason and they don't really care about that. They just want to take a position. But you couldn't conclude that. Given that information is supposedly shared so everybody knows everything, why would all the commercials in the hypothetical, all of the commercials and all of the traditional speculators be on one side and this new money be on the other side?

Dr. PIRRONG. Again, as Professor Irwin said earlier, typically it is the case that commercials are net short and they need somebody to lay off that risk to. One thing that could have been happening recently is that these——

Mr. MARSHALL. I am not talking about recently. I am talking about the hypothetical. I am trying to see whether or not it is hypothetically possible with an experienced person like you, that in a hypothetical like this, the price could be pulled up by money coming in, taking that position that it is not something that the rest of the market understands and they are certainly willing to sell at those kinds of prices.

Dr. PIRRONG. Again, though, it goes back to what I said earlier. If this price were truly distorted, if it were away from where fundamentals would justify, then the people that were willing to pay the high price, they are going to end up actually owning the physical stuff. And to the extent, if you could document that, that would be——

Mr. MARSHALL. They may not own it. But they might regret having taken the position, the willingness to buy at that price.

Mr. Chairman, do you want to take over and wrap it up or do you want me to wrap it up.

The CHAIRMAN [presiding.] We have to get to the next panel.

Mr. MARSHALL. Gentlemen, thank you. I am very interested in hearing, could I do this, Mr. Chairman? Could the three of you talk with one another and see if you can't come together—maybe e-mail back and forth, and see if you can't come together with a statement that you could give us that describes where you fundamentally disagree so that we have a better handle on that?

Mr. KORZENIK. I would certainly be willing to do that.

Mr. MARSHALL. Could you do that in just a couple of days?

Dr. IRWIN. I would be happy to.

Mr. MARSHALL. By Monday?

Dr. IRWIN. We will do our best.

Mr. MARSHALL. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Marshall. We are going to dismiss this panel. Thank you all very much for bearing with us and making your time available, and it has been very valuable to the Committee and we may be calling you again to clarify things. So thank you very much.

We will call the next panel. We will try to get people out of here by 5 o'clock. We have Dr. Jim Newsome, President of NYMEX, who I think all of you know. Christine Cochran, the Vice President of Government Relations for the Commodity Markets Council. Mr. Joe Nicosia, President of the American Cotton Shippers Association. And Mr. Adam White, the Director of Research for White Knight Research & Trading. Welcome all to the panel.

One good thing about being on the last panel, other than you had to sit here all day, is that most Members are not voting, it should go quicker. So, Jim, we appreciate you being with us today and your testimony. To all of the witnesses, your testimony will be made part of the record. And you can summarize your statements in 5 minutes and we appreciate you being here. Thank you.

**STATEMENT OF JAMES E. NEWSOME, PH.D., PRESIDENT AND CEO, NEW YORK MERCANTILE EXCHANGE, INC., NEW YORK, NY; ACCOMPANIED BY THOMAS LASALA CHIEF REGULATORY OFFICER, NYMEX**

Dr. NEWSOME. Thank you, Mr. Chairman. I appreciate the invitation to be here today to testify. Certainly the ever increasing cost of energy touches all aspects of our daily lives and today is quite possibly the most important issue facing both global and domestic economies. This panel is to focus on speculative limits and hedge exemptions and, Mr. Chairman, I will strictly address just those topics.

Speculative activity on U.S. regulated futures exchanges is managed by position limits. These limits effectively restrict the size of a position that market participants can carry at one time. The limits are set at a level that greatly restricts the opportunity to engage in manipulative or abusive activity on NYMEX. Speculative limits adopted or adjusted by NYMEX are submitted to the CFTC for review prior to implementation.

Hedge exemptions are being debated as a possible contributing factor to what is perceived by some as excessive speculation. NYMEX maintains a program that allows for certain market participants to apply for targeted hedge exemptions from the prior set position limits in place on expiring contracts. Hedge exemptions are granted on a case-by-case basis, following adequate demonstration of *bona fide* hedging activity involving the underlying physical cash commodity or involving related swaps contracts. A company is not given an open-ended exemption. The exemption does not allow unlimited positions. Instead, the extent of the hedge exemption is no more than what can be clearly documented in the company's active exposure to the risk of price changes in the applicable product.

Questions have been raised concerning whether or not certain noncommercial customers or swaps dealers are in effect circumventing speculative position limits by obtaining hedge exemptions for noncommercial activity. Related to this issue, we have heard both reckless and unsubstantiated claims that 70 percent of the NYMEX crude oil market is made up of speculators. That 70 percent figure incorrectly assumes that all swaps dealers are noncommercials and that all of their counterparties are also noncommercials. This is simply not the case.

However, this confusion highlights the need for the CFTC large trader data to specify for energy futures the degree of participation by noncommercials in the same manner as is done now for agricultural contracts. This potential gap in the large trader data compiled by the CFTC in its Commitment of Traders report complicates efforts to determine the commercial and noncommercial activity of swaps dealers.

More detailed information from index traders and swaps dealers in the futures market is necessary to confirm that not all over-the-counter energy swap activity undertaken by swaps dealers involves noncommercial participants. In addition, NYMEX believes that these data will allow the CFTC to better assess the amount and impact of this type of trading on the markets.

NYMEX is concerned about restrictions that could be imposed on swaps dealers that could limit the ability of commercial participants to execute strategies to meet their hedging needs. For example, commercial participants often need to have customized OTC deals that can reflect their basis risk for particular shipments or deliveries. In addition, the reality is that not all commercial participants have the sufficient size nor sophistication to participate directly in the futures markets. Swaps dealers assume that risk and then manage it in the futures market.

That said, Mr. Chairman, NYMEX would support a restriction of the ability of a swaps dealer to obtain a hedge exemption from a position limit for activity that concerns OTC transactions involving noncommercial participants. This targeted approach will address the concerns being raised in a thoughtful and deliberate manner and will also reinforce the underlying rationale for the maintenance of effective position limits on speculative activity.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Newsome follows:]

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

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. The ever increasing cost of energy touches all aspects of our daily lives and today is quite possibly the most important issue facing global and domestic economies as well as U.S. consumers. Highlighting the urgency of the matter, no fewer than 19 bills have been introduced in the House and Senate over the last few weeks on this very topic.

The Committee has chosen to focus the discussion on several key issues including margin requirements, hedge exemptions, swap dealers, index funds and foreign boards of trade. NYMEX is pleased to provide its views on the topics of interest that you have identified.

**Margins**

Futures exchanges serve a price discovery and risk management function. Exchanges are neutral as to price levels. In the American free market system, price is determined by the open interplay of market opinion between buyers and sellers. Margin levels should not be used as a tool by the government to artificially control prices. Moreover, any attempt to use margin levels to do so will likely fail. The most important function of margin is prudential—that is, to protect the exchange from credit exposure to its clearing member brokers, and to protect brokers from credit losses from their customers.

In futures markets, margins function as financial performance bonds and are employed to manage financial risk and to ensure financial integrity. Margin takes several forms in the futures industry. First, there is *original margin,* which is the amount of money deposited by *both* buyers and sellers of futures contracts to ensure their performance against the contracts in their account. In addition, on at least a daily basis and sometimes more frequently the futures exchanges collect *variation margin* from both long and short participants to reflect the shifting value of open positions in a given contract. All open positions in regulated futures and options contracts are "marked-to-market" on a daily basis; this daily settlement is a core feature of the financial integrity process for U.S. futures markets because, among other things, it prevents losses from building up beyond 1 day's risk.

The current margin structure used by U.S. futures exchanges and their clearinghouses has consistently demonstrated that it adequately protects the financial integrity of transactions executed on regulated markets. Indeed, no customer or other participant has ever lost money in the history of the Exchange as a result of a financial default by a clearing member.

A number of Congressmen have questioned why futures margin amounts are not the same as securities margin amounts. Unlike margins for transactions in non-exempt securities, futures margin is *not* a down payment against the purchase price of the underlying product. An open position in a futures contract is not an asset and does not result in any ownership unless and until a market participant stands for delivery following termination of trading in the expiring contract month. Instead, futures margin represents a good faith deposit or performance bond to ensure that adequate funds are available in each customer's account to properly settle the trade when it is liquidated. These deposits are intended to cover the financial risk associated with maintaining a futures position by ensuring the financial integrity of transactions cleared by a futures clearinghouse.

By contrast, securities margins are intended to cover the purchase price of the underlying stock and regulation allows the investor to borrow a percentage of that amount from his carrying firm. One short-hand definition of securities margin is the amount of money an investor deposits with a broker when borrowing from the broker to buy securities. The remainder of the cost of the purchase would be financed by the broker. Because securities margin is collected only from the purchaser of the security, it should be noted that a seller would pay no margin in a securities trade, whereas a futures transaction that establishes a new position for buyer and seller would result in collecting margin from both parties.

In addition, the settlement process for securities is notably longer than for futures. While futures transactions are processed and settled within a day of the transaction, securities trades historically take 3 business days for settlement. Beyond the fundamentally different purposes for futures and securities margins, the one-sided nature of securities margins, as well as the longer settlement period, may also account in part for differences in levels as between futures and securities margins.

At NYMEX, margin levels are reviewed daily and are routinely adjusted in response to market volatility. Margin generally is collected to cover a 99 percent probability of a likely 1 day price move, based on an analysis of historical and implied data.

Over the years, there have been proposals made to Congress to increase margins to artificial levels that have no relation to risk levels in order to deter participation in the market. For example, such proposals were made around the time that the CFTC was founded in 1974, as well as in the wake of the stock market crash in 1987. On each occasion, after weighing the prospect of controlling market behavior through margin levels, Congress ultimately rejected such proposals as ineffective and as bad public policy. Thus, the latest proposals to raise margin requirements to artificial levels are essentially recycling theories that have been repeatedly disproven and rejected by Congress in the past.

Nonetheless, those who would push for artificially higher margin levels now are proposing solutions that are apparently premised on three assumptions: (1) that speculators are the primary driver of prices in futures markets, (2) that higher margin levels will drive out speculators; and (3) that higher margins will result in lower prices. Each of these assumptions reflects a fundamental misunderstanding of futures markets and market participants.

The NYMEX Research Department has conducted extensive analysis of WTI futures market data and found no support for an assumption that speculators are pushing prices higher. Data analysis indicates that the percentage of open interest in NYMEX Crude Oil futures held by noncommercial participants (*i.e.,* so-called speculators) relative to commercial participants actually decreased over the last year, even at the same time that prices were increasing. Noncommercial longs and shorts consistently have been in the range of 30–35% of the open interest. Moreover, noncommercial participants are not providing disproportionate pressure on the long or buy side of the crude oil futures market. Instead, noncommercials are relatively balanced between open long (buy) and short (sell) open positions for NYMEX crude oil futures. The attached chart indicates the percentage of open interest in the NYMEX Crude Oil futures contract held by noncommercial longs and shorts relative to that held by commercial longs and shorts. As can be seen, during the last year, commercial longs and shorts have consistently comprised between 65 and 70% of all open interest.

Moreover, on a macro level, speculators are not in a position to be the drivers as to where prices are established in our markets. The crude oil futures contract is a physically delivered contract for a commodity for which OTC and cash markets exist that are each approximately 8–10 times the size of the futures market. There is and can be no credible argument among serious economists and academics who study futures markets that futures prices are driven by developments in the physical market and not *vice versa.*

NYMEX does not believe that raising margin levels is the appropriate tool for dampening speculation. The Commodity Exchange Act specifically directs the CFTC to utilize speculative position limits to control excessive speculation in futures markets. NYMEX has raised margin rates for its crude oil futures contract seven times since the beginning of the year to reflect the increased credit risk from greater price volatility in energy markets.

The base rate that NYMEX charges clearing member firms has risen from $4,500 to $9,250, a 106% increase. Clearing members then collect an even higher margin rate for member customers and a still higher margin rate for non-member customers. The margin required to be posted with such clearing members by non-member customers has increased from $6,075 to $12,488, also a 106% increase. The rates were adjusted by Exchange staff in direct response to the contract's increased volatility.

Margin levels have increased substantially in response to increased market volatility. Year to date, the settlement price of spot month crude oil futures has risen from $99.62 to $140.93 (as of July 2, 2008), a 41% increase. This upward trend continued in spite of crude oil margin being raised seven different times for a total of a 106% increase. As such, the available data does not support the assertion that increasing margins will lower prices.

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.

Although higher margin levels do not result in lower prices, NYMEX has grave concerns that a rash public policy course of action that imposes new artificial margin levels will have a serious and perhaps irreversible impact on a core mission of futures exchanges, which is to provide reliable price discovery. By harming and deterring noncommercial participants who effectively serve as liquidity providers to commercial participants, artificial margin requirements will reduce the attractiveness of U.S. futures markets for commercial participants as compared to other alternatives. In addition, artificial margin levels will clearly result in a distortion of the price discovery mechanism of U.S. futures exchanges from their current robust levels. All other things being equal, commercial participants will have a strong incentive to shift their hedging activity to other markets that have less distortion of the price discovery mechanism.

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 now relevant market fundamentals. Adjusting margin levels significantly upward will not change the underlying market fundamentals, and thus, will not affect price levels. Moreover, by artificially increasing speculative margin levels, it is possible that speculators with short positions may be forced to liquidate their positions, putting even greater upside pressure on the market. 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.

As discussed above, increasing margins will not provide the promised solution of ultimately reducing crude oil prices on regulated futures exchanges. However, this action will have a number of unintended but severe consequences that will harm the regulated markets. Beyond the distortion of the financial risk management process, imposing artificially higher margins would result in:

- A cash and liquidity crisis for many market participants;
- A decrease in liquidity and an associated increase in price volatility;
- A possible increase in intra-day trading to avoid overnight margin requirements, resulting in heightening the impact of short-term price changes, further accelerating price volatility;
- An increase in hedging and other transaction costs for commercials trading on the regulated U.S. exchanges; and
- A shift of business either to less regulated and transparent overseas markets or to unregulated and non-transparent OTC venues in the U.S.

For these reasons, NYMEX believes that Congress should consider the real and perhaps irreparable harm that would result to regulated U.S. futures exchanges from this ill-considered proposal.

**Hedge Exemptions/Speculative Position Limits**

NYMEX has numerous surveillance tools, which are used routinely to ensure fair and orderly trading on our markets. Monitoring the positions of large traders in our market is a critical component to our market surveillance program. 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.

Speculative activity on futures exchanges is managed by position limits. As stated in the CFTC's rules, position limits and accountability levels are required "to diminish potential problems arising from excessively large speculative positions." These limits effectively restrict the size of a position that market participants can carry at one time and are set at a level that greatly restricts the opportunity to engage

in possible manipulative activity on NYMEX. For the NYMEX WTI Crude Oil contract, the position limit during the last 3 days of the expiring delivery month is 3000 contracts. Breaching the position limit can result in disciplinary action being taken by the Exchange.

NYMEX also maintains a program that allows for certain market participants to apply for targeted hedge exemptions from the position limits in place on expiring contracts. Hedge exemptions are granted on a case-by-case basis following adequate demonstration of *bona fide* hedging activity involving the underlying physical cash commodity or involving related swap agreements. A company is not given an open-ended exemption, and the exemption does not allow unlimited positions. Instead, the extent of the hedge exemption is no more than what can be clearly documented in the company's active exposure (as defined by the CFTC) to the risk of price changes in the applicable product. In a number of instances, hedge applications are either reduced in number or are denied because of staff's overriding focus on maintaining the overall integrity of our markets.

**Role of Swap Dealers**

Turning specifically to data relating to the activity of swap participants since October 2007 until early June 2008, these data provide a very different result than what is being publicly asserted by commentators who choose not to burden their arguments with the facts. This is a key finding; a closer analysis of such data, including data obtained from the CFTC, reveal that swap dealers participating in our markets were in fact holding overall net short (sell side) positions. In other words, unlike the public posturing of those who blindly assert that swap dealers are providing upward pressure on price, the simple reality is that, in the recent past, any price impact that may be attributable to their open positions has generally been to lower prices somewhat and not to raise them.

We have seen various representations made relative to participation by speculators in our markets that directly contradict our data. One such representation claims that 70% of our crude oil market is made up of speculators. That analysis incorrectly assumes that all swap dealers are noncommercials and that all of their customers who would be on the opposite side of any energy swap that they might execute would also all be noncommercials. This is simply not the case. However, this confusion clearly highlights the need for the CFTC large trader data to delineate for energy futures the degree of participation by noncommercials in the same manner that such data are now being delineated for agricultural contracts.

This potential gap in the large trader data compiled by the CFTC in its Commitment of Trader's Report complicates efforts to determine the extent of commercial and noncommercial activity of swap dealers. As a result, questions are being raised as to whether hedge exemptions for swap dealers are being used as a means of circumventing speculative position limits. At this time, due to the manner in which the data are reported, it is not clear whether this is true or not. In response to these queries, the CFTC announced its intent to develop a proposal that would routinely require more detailed information from index traders and swaps dealers in the futures markets, and to review whether classification of these types of traders can be improved for regulatory and reporting purposes. NYMEX is confident that these data will confirm that not all of the over-the-counter (OTC) energy swap activity undertaken by swap dealers involves noncommercial participants. In addition, NYMEX believes that these data will allow the CFTC to better assess the amount and impact of this type of trading on the markets.

NYMEX is concerned about restrictions that could be imposed on swap dealers that could limit the ability of commercial participants to execute strategies to meet their hedging needs. For example, commercial participants often need to have customized OTC deals that can reflect their basis risk for particular shipments or deliveries. In addition, not all commercial participants have the sufficient size or sophistication to participate directly in active futures markets trading. Swap dealers assume that risk and lay it off in the futures market.

Nevertheless, NYMEX would support a restriction on the ability of a swap dealer to obtain a hedge exemption from a position limit for activity that concerns OTC transactions involving noncommercial participants. This focused or targeted approach will address the concerns being raised in a thoughtful and deliberate manner and also will support and reinforce the underlying rationale for the maintenance of effective position limits on speculative activity.

**Role of Index Funds**

Unfounded assertions have raised concerns about a perceived dramatic increase in the level of participation by pension funds and index fund participants in NYMEX's Crude Oil futures contract. As a result, legislative proposals to limit the

participation of such entities in energy futures contracts are under consideration. While the arguments advancing such assertions are riddled with errors, one rather sophomoric error is particularly egregious and does not warrant uncritical acceptance.

Specifically, some commentators with no obvious expertise in futures markets have estimated levels of investment in Index Funds (or structured instruments based on Indices). These estimates are, in part, derived from data on participation in certain agricultural commodity futures contracts and are wholly based on several assumptions including one that the agricultural components of the index investments are entirely hedged in related agricultural commodity futures contracts. The commentators then make the leap in logic that any market exposure related to investment in the index will always and automatically be hedged by establishing positions in futures contracts for each of the 25 commodities comprising the index. It is possible this reflects current practice for some or perhaps most of the agricultural commodities.

In 2000, Congress declined an opportunity to provide the same level of legal certainty to OTC swaps in agricultural products that are now available to swaps in financial and energy products. Consequently, by virtually all accounts, the market for agricultural OTC swaps is far less developed than for energy swaps. Indeed, the OTC energy market currently dwarfs the size of the regulated futures market for energy products. So, while it would be understandable that index positions in the agricultural commodities of an index would be hedged, at least at present, on the regulated futures exchange, the OTC venue is far more viable for energy products.

Thus, it is inaccurate to assume that energy markets operate in the same manner as agricultural markets, and it is equally wrong to presume that the same practice for agricultural commodities automatically will carry over to index fund activity as it concerns energy futures. An index fund provider could hedge its position either by establishing a position in the related energy futures contract on a regulated exchange or by entering into a swap or other derivatives transaction in the OTC market.

The actual structure of energy derivatives markets is also supported by recent statements by companies engaged in the index business. Donald Casturo, an executive at Goldman Sachs, recently noted that "85% of this investment (Index investing) takes place on the OTC market." (CFTC Energy Markets Advisory Committee meeting, Washington, D.C., June 10, 2008). Rather than incur the cost of entering into transactions on regulated futures exchanges for each of the 25 commodities comprising its index, companies such as Goldman Sachs find it more cost-effective to hedge their exposure, at least with respect to energy products, predominantly via one OTC swap transaction with another swap dealer.

The consequence of this practice is that only a modest portion (at best) of increases in participation in the index contracts results in actual increases in activity in the NYMEX crude oil futures contract. Furthermore, no credible empirical evidence has connected participation in Index Funds with price impacts in the crude oil market. In fact, independent analyses performed by the CFTC over different time periods have indicated that participation by financial non-oil entities, even when their net-participation is on the "long" side in futures, has had no statistically significant impact. Thus, the sweeping and dramatic claims and assertions being made by those commentators new to the futures industry are not only wildly exaggerated; they are simply wrong.

NYMEX does not believe that the case has been made to support a finding that institutional investors are contributing to the high price of crude oil; contrary assertions are founded upon false comparisons that can be swiftly dismissed. It would be premature to adopt a legislative solution for an unproven and unsubstantiated problem. NYMEX recommends requirements to provide additional transparency to enhance the ability to monitor these markets. This approach will avoid undue harm to investors and to the markets. Finally, NYMEX believes that prohibiting investment opportunities of institutional market participants would effectively substitute the judgment of Congress for the judgment of trained financial investment professionals. We urge Congress to move with deliberation and caution in this area.

**Foreign Boards of Trade**

Over the last few years, new developments have occurred related to products offered by non-U.S. exchanges (also referred to as foreign boards of trade (FBOT)) to U.S. customers. FBOTs, which are permitted by CFTC staff to offer their products to U.S. customers pursuant to CFTC No Action letters, began listing futures contracts with U.S. delivery points among their product slates. Historically, under the CFTC staff's FBOT no-action process, such exchanges were permitted to offer direct electronic access to their markets to U.S. customers based on a determination by

CFTC staff that the foreign regulatory regime governing the FBOT was "comparable" to that of the CFTC.

Essentially, there is a system of mutual recognition among regulators around the world as a means to facilitate access to global markets. This approach worked effectively up until one FBOT listed the look-alike of the NYMEX West Texas Intermediate (WTI) Crude Oil Futures contract without the level of transparency and market surveillance controls, such as positions limits, that are provided by U.S. markets under direct CFTC regulation. It was not anticipated that the no-action process would be used in this manner. The current policy, which permits the FBOTs to list look-alikes of U.S. futures contract, has effectively diminished the transparency to the CFTC of approximately ⅓ of the WTI crude oil market, and permitted an easy avenue to circumvent position limits designed to prevent excessive speculation.

Two years ago, NYMEX cautioned that allowing a foreign exchange to list a futures contract virtually identical to a contract traded on a U.S. futures exchange without comparable regulations, such as position limits, could be a slippery slope. We argued that the wrong policy decision could threaten the CFTC's jurisdiction over an important price discovery contract. At that time, the CFTC had jurisdiction over 100 percent of the WTI crude oil futures markets; today, it has jurisdiction over approximately 60 percent of the WTI crude oil market.

In our recent experience, "regulatory arbitrage" is not a hypothetical concern, but is a reality for certain NYMEX listed products. Customers are making choices among the same or similar products on the basis of differences in regulatory treatment rather than on the basis of intrinsic distinctions in the products. For example, customers can carry WTI positions above the position limits for WTI contracts established on NYMEX by shifting their business to ICE Futures Europe where position limits are not mandated by its London regulator, the Financial Services Authority. Thus, regulatory arbitrage potentially diminishes the breadth and depth of the CFTC's regulatory authority and, consequently, reduces much needed market transparency. Complete transparency to the CFTC should be a fundamental requirement for markets that are linked.

Various legislative proposals have been introduced to address FBOTs that list energy contracts that are based on commodities delivered in the U.S. or are otherwise linked to contracts traded on U.S. futures exchanges. NYMEX would support proposals that would require a comparable regulatory scheme for FBOTs that list look-alikes of U.S. futures exchange contracts or contracts that are otherwise linked to U.S. contracts. Comparable requirements should include position limits/accountability levels, large trader reporting and emergency authority. Overall, we have argued that FBOTs offering linked products should be required by the CFTC to provide the same level and quality of data and with the same frequency that U.S. exchanges provide daily to the CFTC. NYMEX believes that this targeted approach will effectively address the regulatory gap that currently impedes the CFTC's ability to monitor the entire U.S. WTI crude oil futures contract.

NYMEX would not support other more expansive proposals that call for full registration by FBOTs offering U.S.-delivered or linked contracts. U.S. exchanges, including NYMEX, have placed trading screens in a number of foreign countries around the world to offer our products to foreign customers. There is considerable risk of retaliation by those countries, including a similar registration requirement in each foreign location where we are offering our products. Such a result would impede significantly the global competitiveness of U.S. markets.

The CFTC recently announced several initiatives to address the growing concerns about an FBOT trading the U.S. benchmark WTI contract. It has reached an agreement with the FSA and ICE Futures Europe to receive enhanced data to allow the CFTC to see both U.S. participants in the London markets and foreign traders that it would not normally oversee. In addition, the CFTC announced that it would revise its FBOT policy and require ICE Futures Europe to establish comparable position limits and accountability levels on its crude oil contracts that are linked to NYMEX crude oil contracts.

This would be a positive step and would provide an effective mechanism to restrict speculative activity in those markets. This is particularly important when the contract trading on the FBOT is the WTI crude oil contract, which is a benchmark for crude oil pricing, and which can have a substantial impact on U.S. consumers and the U.S. economy. Indeed, we would support the imposition of position limits even for listed contracts that are financially settled. We applaud the CFTC's recent initiatives.

NYMEX continues to believe that the CFTC's no-action process for offering foreign products to U.S. customers is an important vehicle for global competitiveness of U.S. markets. Approximately 1 year ago, a new futures exchange, the Dubai Mercantile

Exchange (DME), commenced operations in Dubai. NYMEX is a founder and has an ownership share in this venture and provides clearing services for the new exchange. The core or flagship crude oil futures contract is an Oman Sour Crude Oil futures contract. The DME initiative provides competition and greater transparency to crude oil trading in a critically important energy region.

Although the DME does not yet list a WTI financial futures contract, the DME has received a No Action letter from the CFTC staff for this contract. The DME is currently finalizing a launch date for that contract. It is our understanding that, when a launch date is finalized on the DME WTI contract, DME will implement hard position limits that are comparable to NYMEX's own limits on our WTI crude oil futures contract. Also, as part of the NYMEX Clearing Order, large trader reporting to both the CFTC and NYMEX is required.

In a more recent initiative, NYMEX has entered into an alliance with a London-based clearinghouse, LCH.Clearnet Limited (LCH), under which LCH will provide clearing services for two new product slates to be launched later this summer either by NYMEX or by a NYMEX affiliate. These new product slates are intended to provide greater competition to other energy trading facilities that are active in this energy space. One product slate, focusing upon natural gas and electricity contracts, will be listed by a division of NYMEX in the exempt commercial market tier. Applicable products in this category will comply fully with the requirements for significant price discovery contracts contained in the recently implemented CEA reauthorization farm bill.

The other product slate, focusing upon crude and crude products, will be listed for trading by a NYMEX affiliate based in London that will be regulated by the FSA. That affiliate will follow the path of other exchanges regulated by other regulators and will apply for CFTC no-action relief. Notably, the affiliate will provide large trader reporting to the CFTC and also will impose hard position limits on any listed contracts with U.S. delivery points.

**CFTC Resources**

The landmark Commodity Futures Modernization Act of 2000 (CFMA) ushered in a period of phenomenal growth in U.S. derivatives markets. The industry growth, however, has not been matched by increased resources needed for the CFTC to oversee those markets effectively. We believe that a compelling case has been made for immediate increases in the size of the CFTC's operating budget. My own views on the need for remedying this mismatch between duties and resources stem in part from my service as Chairman of the CFTC from 2002–2004 during the period when we were continuing to implement the provisions of the CFMA. As anticipated, that law brought new competition and enhanced innovation in derivatives markets, which contributed to the explosion in trading volume. It is imperative that the CFTC have all of the tools that it needs to carry out fully its obligation to maintain the integrity of U.S. futures markets.

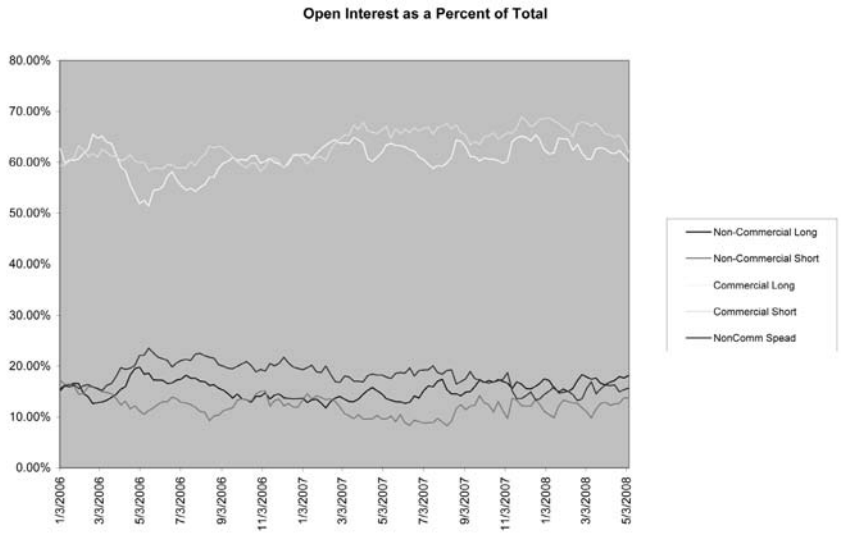
**Conclusion**

Complete transparency is fundamental for competitive markets. The same level of transparency and position size controls present on regulated U.S. futures markets should be the standard for foreign markets offering products with U.S. delivery points and for OTC contracts that serve a price discovery function. Additionally, NYMEX believes that disaggregation and delineation of positions held by swap dealers is necessary. This will provide important information to determine whether speculative position limits are being avoided by index funds and other institution investors and whether their activity is influencing market prices. However, a case has not been made for excluding institutional investors from participation in derivatives markets, nor for eliminating hedge exemptions for swap dealers to the extent the exemptions cover risks related to commercial activity.

Many factors are contributing to high energy prices. NYMEX continues to believe that market fundamentals are a significant factor that must not be discounted in this debate. Increasing margins to dampen speculative activity will not change the fundamentals and will inevitably drive business away from the highly regulated, transparent marketplace. This will do more harm than good.

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.

ATTACHMENT




The CHAIRMAN. Thank you, Mr. Newsome. And next we have Christine Cochran. I appreciate you being with the Committee.

**STATEMENT OF CHRISTINE M. COCHRAN, VICE PRESIDENT, GOVERNMENT RELATIONS, COMMODITY MARKETS COUNCIL, WASHINGTON, D.C.**

Ms. COCHRAN. Thank you, and good afternoon, Chairman Peterson and Members of the Committee.

The CHAIRMAN. Your mic is not on, I don't think.

Ms. COCHRAN. Thank you. Chairman Peterson, Members of the Committee, good afternoon. My name is Christine Cochran, and I am the Vice President of Government Relations for the Commodity Markets Council. I would like to thank you for hosting this series of hearings, as well as inviting us to participate.

CMC is a trade association that represents commodities futures exchanges and exchange participants. Our membership includes the complete spectrum of commercial users of the agricultural and energy futures markets. I would like to emphasize that the businesses of all of our industry members depend upon the efficient and competitive functioning of the risk management tools traded on U.S. futures exchanges.

CMC strongly supports your efforts and those of the Commodity Futures Trading Commission to seek greater visibility into the commodity markets, especially in the energy markets. We believe this visibility will lead to improved market transparency and is the first step to maintaining responsible commodity markets.

CMC has confidence in the CFTC's ability to gather and analyze this data. For example, in 2006, we led the industry effort and worked with the CFTC to increase transparency on the index traders in the grain markets through the Commitment of Traders Supplemental report. Based on data collected by the CFTC, the Com-

mission has created a report that is already one of the grain industry's most essential tools for analyzing markets. We believe that applying this same principle to other commodity markets will significantly benefit market regulators, traditional market users, as well as the general public.

In the last decade, futures markets, especially in the enumerated agricultural commodities, have grown immensely because of the relevance of their product to the commercial hedging, financial hedging and general international and trading communities. This includes hedge funds, index funds and institutional investors. The increase in volume has boosted liquidity, aided in price discovery and enhanced market efficiency for all market participants.

CMC views the investment activity of institutional investors and index funds as legitimate financial hedging, but we recognize that it is passive in nature and not responsive to price levels. Some believe that this activity is the reason for current price levels. However, based on the data available to us at this time, CMC does not believe that that is the case and therefore we cannot support proposals that would ban any group of legitimate investors from participating in commodity markets. Instead we believe that additional reporting could allow the CFTC to identify possible manipulative behavior. It could also help market participants better understand the role of these investors in the market.

We encourage you to also weigh the possibility that banning or severely restricting this type of participant will not accomplish the intended purpose. The money is not going to disappear. Instead it may move offshore and take with it valuable market liquidity, or it could move into other markets and take with it valuable transparency.

CMC supports the CFTC's recent decision to take a go-slow approach in expanding exemptions for this new class of investor. This decision will allow the Commission and market users more time to thoroughly evaluate the impact this passively invested money may have on commodity markets. Futures markets today reflect global economic trends, not speculative buying power. Based on the information that we have currently available, CMC believes speculative activity in the futures market may influence day-to-day prices as it always has, but it is the fundamental forces of supply and demand that create and sustain the price levels we see today.

To address the concerns surrounding the new investor in the commodity markets, CMC has two policy recommendations. One, we believe the Commission should continue to monitor index funds and be prepared if necessary to examine the structure of the hedge exemption granted to such funds. And two, we recommend that the CFTC initiate a study of the trend towards alpha or enhanced return trading by index and hedge funds because this type of investment is price responsive and not passively managed. We believe it is speculative in nature and should be reported as such on the supplemental report.

CMC also supports the efforts of the Commission to gather more information regarding swap transactions and would support greater transparency of such transactions. However, we also believe that swaps contracts provide a legitimate and important commercial service. A swaps contract is between two private parties. So it can

provide a highly customized service that cannot be obtained in an on-exchange contract.

In conclusion, CMC believes that the commodity industry is in a volatile period due to supply and demand fundamentals reaching new thresholds. Our system of open and competitive markets, coupled with proper government oversight, has positioned our market participants to read, understand and respond to market signals efficiently. Before any drastic changes are considered, we strongly urge you to seek additional transparency and evaluation and have great confidence in the CFTC's ability to provide that. More information will help regulators, traditional market participants and the general public understand the impact this new class of investor is having on the market.

Mr. Chairman, we compliment you and the Committee's efforts and we look forward to working with you and answering any questions that you may have.

Thank you.

[The prepared statement of Ms. Cochran follows:]

PREPARED STATEMENT OF CHRISTINE M. COCHRAN, VICE PRESIDENT, GOVERNMENT RELATIONS, COMMODITY MARKETS COUNCIL, WASHINGTON, D.C.

Mr. Chairman and Members of the Committee:

Good morning. My name is Christine Cochran and I am the Vice President of Government Relations for the Commodity Markets Council (CMC).

Mr. Chairman and Ranking Member Goodlatte, the issues you plan to address in this series of hearings are very important to the industry I represent. I would like to thank you for hosting them and for inviting CMC to participate.

CMC is a trade association that represents commodity futures exchanges, regional boards of trade, and numerous industry counterparts in the agriculture and energy businesses, including domestic and multinational commodity merchandisers, processors, millers, refiners, commercial and merchant energy companies, precious and base metal trading firms, and bioenergy producers; U.S. and internationally-based futures commission merchants; food and beverage manufacturers; major transportation companies; and financial institutions.

Representing the complete spectrum of commercial uses of the agricultural and energy futures markets, the activities of our members range from grain and energy hedging by local country grain elevators to highly sophisticated, high-volume hedging activities supporting domestic and international grain and other agricultural product merchandising, exporting, and processing operations. The businesses of all our non-exchange member firms depend upon the efficient and competitive functioning of the risk management products traded on U.S. futures exchanges.

The passage of the Commodity Futures Modernization Act of 2000 (CFMA) shifted the regulatory philosophy from prescriptive regulations to core principles. This shift explicitly recognized the success of the self-regulatory organization (SRO) model and entrusted U.S. exchanges with broad authority to offer products and services to expand their businesses, attract customers, and compete domestically and globally. Since that time, U.S. futures exchanges have grown rapidly and the community of exchange users have benefited tremendously. U.S. capital markets are also an important beneficiary of this dynamic growth. The success of the U.S. futures business has helped sustain the U.S. as the centerpiece of global risk management.

Before adopting any new proposals, CMC strongly encourages you to consider increasing market transparency. Greater transparency, we believe, is the first step to maintaining responsible commodity markets. It will provide more accurate and useful information about all classes of market participants. In 2005–2006, CMC led the industry effort to increase transparency on index traders in the grain markets through the Commitment of Traders (COT) Supplemental Report, which is already one of the grain industry's most essential tools for analyzing markets. We believe that applying the same principle to other commodity markets will significantly benefit the market regulators, traditional market users, and the general public.

The businesses of all CMC members depend on market integrity and we strongly support the Commodity Futures Trading Commission's (CFTC or Commission) efforts to investigate and prosecute market manipulation. Ferreting out market par-

ticipants that attempt to inappropriately influence the market is critical to protecting customers and keeping the trust of the trading public. Simultaneously, we need to ensure that U.S. markets continue to serve as global benchmarks and continue to provide efficient price discovery.

As you evaluate the complicated issues before you, CMC encourages you to continue to follow the directions set by the core principles of the CFMA.

**Institutional Investors and Hedge Funds in Commodity Markets**

CMC views the investment activity of institutional investors and index funds as legitimate "financial hedging," but we recognize that it is passive in nature and not responsive to price levels or supply and demand fundamentals. In 2005 and 2006, CMC worked closely with the Commissioners and staff of the Commodity Futures Trading Commission (CFTC) to deepen the industry understanding of the nature of index fund activity in futures markets. The result of this collaborative effort was the CFTC's release of a new Commitment of Traders (COT) Supplemental report showing index fund financial hedges as a separate and distinct category.

We believe the COT Supplemental Report provides greater transparency in the grain market about the size and behavior of such investors. Despite being a relatively young report, it is already one of the industry's most essential tools for analyzing markets.

Some believe that the activities of large institutional investors in futures markets are the reason for current price levels; however, based on the information currently available, CMC does not believe that this is the case. As an advocate for open competitive markets, we do not support drastic proposals that ban any group of legitimate investors from participating in commodity markets. At the same time, CMC wants to emphasize that we in no way support or condone manipulative behavior. With the information currently available to us, CMC does not believe that pension funds or large institutional investors are having a significant impact on commodity prices; however, we strongly support increasing transparency. Additional transparency would allow the CFTC to identify possible manipulative behavior, and it would help market participants better understand the role these investors may play in the market.

CMC also encourages you to weigh the possibility that banning or severely restricting this type of participant will not accomplish the intended purpose. The money will not disappear; instead, it may move offshore and take with it valuable market liquidity. It is important to be informed, thoughtful, and prudent as we evaluate restrictions on a class of market participants.

The CFTC recently indicated that it will take a "go-slow" approach in expanding exemptions for this new class of investors. CMC supports this regulatory approach because it will allow the Commission and market users more time to thoroughly evaluate the potential this passively invested money may have on commodity markets. The additional transparency that we are calling for would provide the tools necessary for market participants to evaluate the impact of this new class of investor.

Equally important is the distinction between passive investment and price-responsive investment. Typically index funds and institutional investors engage in passive investments. They take a position and hold it until a determined time. They do not change their position based on market movements. Meanwhile, hedge funds tend to be more responsive to market signals and act as a traditional fundamental trader. As such, hedge funds are subject to position limits which are appropriate.

In the last decade, futures markets, especially in the enumerated agricultural commodities, have grown immensely because of the relevance of their products to the commercial hedging, financial hedging, and general international and domestic trading communities—including hedge funds, index funds, and institutional investors. This increase in volume boosts liquidity, aids in price discovery, and enhances market efficiency for all market participants.

Futures markets today reflect global economics and trends, not speculative buying power. Based on the information currently available to us, CMC believes speculative activity in futures markets may influence day-to-day prices, as it always has. On the other hand, it is the fundamental forces of supply and demand that creates and sustains the price levels we see in the markets.

*Policy Recommendations To Consider*

To address the concerns surrounding this new investor in commodity markets, CMC recommends:

1. *Monitor Index Fund Positions.* To maintain competitive markets, exchanges and the CFTC should continue to monitor index fund participation and be pre-

pared, if necessary, to examine the structure of the hedge exemptions granted to the funds.

In the agriculture futures markets, volume grew immensely in the last decade and the increased liquidity benefited all market participants. Fund investment contributed to this prosperity, and CMC believes that the CFTC and lawmakers should move slowly when adopting measures that will discourage such participation in the markets.

2. *CFTC Study Of Alpha Trading.* CMC also recommends that the CFTC initiate a study of the trend toward "alpha" or "enhanced return" trading by index and hedge funds. Because this type of investment is price-responsive and not passively managed, CMC believes it is speculative in nature and should be reported as such on the CFTC COT Supplemental Report.

3. *Continued Product Innovation.* As the markets evolve and learn to adapt to the changing supply and demand dynamics, CMC would support legislation and regulations that allow exchanges to continue to innovate and create new products to manage risks.

**CMC Grain Futures Performance Task Force**

With unprecedented challenges facing the U.S. grain markets, CMC brought together exchanges and exchange-users to discuss futures market performance. The Task Force reviewed many market-related issues with the participants and the role of institutional investors and hedge funds was a significant point of discussion.

The overriding concern expressed by participants is the financial impact of high commodity prices and increased price volatility—not futures market performance. Most market participants agree that current supply and demand fundamentals support high commodity prices. They do not believe that institutional investors or hedge funds are pushing price levels higher. Specifically, participants identified the following as the primary reasons for current price levels:

1. Strong economic growth in developing countries such as China and India resulting in increased demand for commodities.

2. Increased demand for commodities used for biofuel production and government mandates on biofuel use that result in inelastic demand for grains and vegetable oils.

3. Reduced yields in major producing regions due to weather events that are resulting in historically low world grain stocks-to-use ratios.

4. Export restrictions imposed by other nations.

5. A weakening U.S. dollar.

At the same time, the increased pressure in the credit markets is increasing the need for consistent convergence.

Consistent convergence was the primary topic regarding technical futures market performance. While most participants agree that basis weakens in high price environments relative to more normal market conditions as grain and oilseed handlers' increased risk is incorporated in lower cash grain bids, participants still expect consistent basis strengthening as futures markets approach expiration. Some Task Force participants have disagreed on why convergence has been inconsistent—citing either insufficient storage charges on futures market receipts and certificates; index fund and/or speculative activity in the market; or the multitude of external shocks hitting the market. Most of those interviewed by the Task Force urged Exchanges to not make drastic changes until the markets adjust to this new operating environment.

The panel discussed a number of proposals that might improve convergence, but no broad consensus emerged from the process. Nonetheless, the largest number of participants generally supported increasing storage rates. Participants also supported seeking CFTC approval to clear OTC grain swaps.

**The Role of Swaps in Commodity Markets**

CMC supports the efforts of the Commission to gather more information regarding swaps transactions and would support greater transparency of such transactions. However, we also believe that swaps contracts provide a legitimate and important commercial service.

A swaps contract is between two private parties, so it can provide a highly customized service that cannot be obtained in on-exchange contracts. For example, a commercial company may seek to secure a hedging position that extends over a 5 year period, but on-exchange futures contracts are not available that far out. In the over-the-counter market, the company can enter into a swaps agreement with another willing party for the desired terms. This arrangement meets the hedging

needs of the commercial company seeking the position. It also creates risk exposure for the counterparty, which is often managed over time on-exchange.

**Aggregating Speculative Position Limits**

Aggregating speculative position limits could cause serious harm for existing markets by grouping contracts that serve distinct purposes and by severing liquidity between markets.

It is critical that any policy seeking to aggregate speculative position limits accounts for the difference between existing contracts. Wheat is traded on the Chicago Board of Trade, Kansas City Board of Trade, and Minneapolis Grain Exchange; however, each wheat contract is distinct and provides a unique risk management solution. For example, a company hedging soft red winter wheat flour on the Chicago Board of Trade is hedging ingredients in pastries, cakes, and pie-crusts, while a company hedging hard red spring wheat flour on the Minneapolis Grain Exchange is hedging ingredients in bread.

Another possible consequence from aggregating speculative position limits is the division of the liquidity that currently exists between exchanges. If position limits in similar contracts are aggregated and subjected to existing speculative position limits, then firms, including commercial firms, may be forced to either reduce their positions in each individual market or move their positions to one market. This shifting of positions could severely reduce liquidity on existing exchanges and negatively impact all market participants.

Some proposals currently being consider would apply aggregate speculative position limits for on-exchange products and OTC products. Given the customized nature of over-the-counter commodity contracts, our members, who are active in both markets, we would appreciate caution when examining such a proposal.

**Margin Requirements**

With commodity prices moving higher and higher, CMC shares the concerns of many lawmakers, but we remain confident in the ability of CFTC professional staff to monitor and evaluate trading in all commodity markets, as well as their conclusions about the impact of speculation on prices in those markets.

CMC is concerned about calls to require the CFTC to set substantially higher margin levels in the energy markets. It appears the intent of such proposals would be to lower prices; however, we believe that increased margin requirements could force many market participants off-exchange and into less transparent markets.

A margin payment, also called a performance bond, is the amount of money or collateral deposited by either a customer with a broker, a broker with a clearing member, or a clearing member with a clearing organization. A margin payment does not serve as a partial payment on a purchase, but rather serves to manage counterparty risk and ensure the financial integrity of the markets. Raising margin requirements will not reduce volatility or manage prices. It will increase the cost of futures transactions and potentially push liquidity from the regulated exchange marketplace.

In conclusion, CMC believes the commodity industry is in a volatile period due to supply and demand fundamentals experiencing new thresholds. Our system of open and competitive markets coupled with proper government oversight positions market participants to read, understand, and respond to market signals efficiently. Before any drastic changes are considered, we strongly urge you seek additional transparency and evaluation. More information will help regulators, traditional market participants, and the general public understand the impact this new class of investor is having on the market.

Mr. Chairman, we compliment you and Mr. Goodlatte for your efforts and we look forward to working with you. Thank you.

The CHAIRMAN. Thank you, Ms. Cochran. Mr. Nicosia. Am I right about that?

Mr. NICOSIA. Nicosia.

The CHAIRMAN. I apologize.

Mr. NICOSIA. That is okay.

## STATEMENT OF JOSEPH T. NICOSIA, PRESIDENT, AMERICAN COTTON SHIPPERS ASSOCIATION; CEO, ALLENBERG COTTON CO., CORDOVA, TN

Mr. NICOSIA. Chairman Peterson and Members of the Committee, I am Joe Nicosia of Memphis, Tennessee. And I appear

today in my capacity as President to the American Cotton Shippers Association. Accompanying me today is the Executive Vice President and General Counsel, Neal Gillen.

I am the CEO of Allenberg Cotton Company and a member of the Executive Committee of the Louis Dreyfus Corporation. I oversee the worldwide trading of cotton and also trade grains, oilseeds, livestock, currencies and energy.

My prepared testimony reviews the recent changes made by the ICE exchange in the cotton contract and the recent action by CFTC. The ICE has agreed to take our recommended changes to margin futures-to-futures settlements and options-to-options settlements. It has also agreed to the industry's proposal regarding the expansion of trading limits.

While the CFTC has focused primarily on the monitoring of energy markets, it has launched a comprehensive investigation into the February and March trading in the cotton futures contract. It has also developed a proposal to require more detailed reporting from index traders and swap dealers and to review whether classification of these types of traders can be improved for regulatory and reporting purposes.

I would add that it was not possible for the Commission to effectively regulate the futures market because it had never used its authority to request such information. The lesson here is that lacking the appropriate information, the markets cannot be properly monitored.

More importantly, CFTC has agreed to review the trading practices for index traders to ensure that this type of trading activity is not adversely impacting the price discovery process and to determine whether different practices should be employed.

Mr. Chairman, this is the crux of the matter. Different regulatory practices must be employed, and let me explain why. From December to late February, the net long position in cotton futures contracts of the noncommercial and index traders rose by 9.5 million bales. At its peak during the last week of February, the position reached 21½ million bales compared to the entire U.S. crop of only 19.2 million bales, effectively cornering the market. This huge position in cotton futures contract had nothing to do with ownership of the physical bales of cotton. And more importantly, in the 2 week period leading up to the explosion in cotton prices, the passive index funds increased their position by 16 percent and then reduced their position by 10 percent the following week after the price explosion. Their activity was anything but passive.

The current practices of providing a hedge exemption to index funds is flawed, inconsistent with hedge requirements, and leads to disruptive and divergent price action in both the cash and futures prices. A traditional hedger can only trade futures in excess of his speculative position limit to the extent that he has valid cash sales or purchases of production or consumption needs. If a hedger desires to have a position in excess of these limits simply because it has more money put to use or desires additional price exposure, that hedger will be denied such right. And yet an index fund is granted that right solely based on the fact that it has more money seeking price exposure.

In addition, since an index fund with a hedge exemption is not required to act with an economic purpose in regard to the cash market, it is allowed to continue to purchase futures levels that are not justified by the cash market. This causes a breakdown in the traditional cash futures relationship and impedes the proper convergence of price between the cash and futures.

Normally this would provide a profit opportunity for the hedger. However, the size of the index fund position is so massive, and we have data that we can share with you, that those positions are so massive that it overwhelms the industry's capacity to arbitrage the divergence; and thus convergence cannot take place. Therefore, by requiring an index fund to adhere to the same requirements as a traditional hedger would greatly enhance convergence as well as provide capital to the cash markets.

As I stressed in our prepared statement, the CFTC needs to aggregate all positions and market exposures to determine an entity's total position. If I, as a commercial hedger, must report full information, then so too should other trading entities. It is not only logical, it is equitable, but the CFTC and the trading public should also have this information so as to make sound regulatory and trading decisions.

Another obvious reason that index funds can be used to circumvent, is that they can be used to circumvent speculative position limits. Index funds are able to take large investments from any one entity with a total disregard as to whether that investor measured as an individual may be over his speculative position limits. If an entity wants to exceed its position limits, it simply invests additional money into an index fund or swap and completely circumvents the CFTC regulation.

While we are pleased that the CFTC has placed a moratorium on granting further hedge exemptions to the so-called passive investment funds, action must be taken to strike a balance between those funds that are currently operating under a hedge exemption. We submit that CFTC should take immediate action to require that an index fund with a hedge exemption restrict its position to a commodity in the commodity to the dollar allocation, or to the percentage of funds allocated to that commodity as defined in the fund's prospectus.

We also recommend that the CFTC monitor and oversee all swap and OTC activity by requiring the reporting of all swap and OTC contracts by market participants and that the CFTC determine the aggregation of those positions from all sources, including exchanges, ETFs, swaps, index investments, OTC and other trading entities.

We also recommend that the CFTC require all nontraditional hedge accounts, those not involved in the commercial enterprise of physical trading of bales, to be reported as a separate individual category.

In our view, these requirements would provide the CFTC and the trading public with the necessary information on which to make sound regulatory and market decisions. It will hopefully attenuate the current situation in which these essential markets have become investment vehicles for speculative funds who act unimpeded by market fundamentals or regulation.

Again, Mr. Chairman, thank you for providing us the opportunity to participate in these important hearings and for your attention to our concerns. Hopefully your legislative findings and recommendations will result in full market transparency, revealing the necessary data that will allow the CFTC to know firsthand what is taking place in the markets so they can make sound regulatory decisions.

Thank you.

[The prepared statement of Mr. Nicosia follows:]

PREPARED STATEMENT OF JOSEPH T. NICOSIA, PRESIDENT, AMERICAN COTTON SHIPPERS ASSOCIATION; CEO, ALLENBERG COTTON CO., CORDOVA, TN

Chairman Peterson, Ranking Member Goodlatte, and Members of the Committee, I am Joseph T. Nicosia, of Memphis, Tennessee. I appear today in my capacity as President of the American Cotton Shippers Association (ACSA). Accompanying me today is ACSA's Executive Vice President & General Counsel, Neal P. Gillen.

I am the CEO of Allenberg Cotton Company and a member of the Executive Committee of the Louis Dreyfus Corporation. I oversee the trading of cotton and also trade grains, oilseeds, livestock, currencies, and energy.

The concerns and some of the recommendations expressed in this statement are shared by the entire U.S. cotton industry—producers, ginners, warehousemen, merchants, cooperatives, and textile mills. For the past 4 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 IntercontientalExchange (ICE), the Commodity Futures Trading Commission (CFTC), and the Congress.

**Recent Developments**

We are pleased to inform you that the ICE has been responsive to our concerns, and so to has the CFTC, which has actively considered and adopted some of the recommendations we made to the Commission's April 22nd Roundtable. Further, we appreciate the scheduling of this week's hearings and the overall sense of urgency by many in the U.S. Congress to determine what can and should be done. Your involvement is another example of the concerns expressed by this Committee to effectively oversee the futures markets by addressing these important issues. Hopefully, your legislative findings and recommendations will result in full market transparency revealing the necessary data that allows the CFTC to know first-hand what is taking place in the markets so it can make sound regulatory decisions providing for the orderly trading of agricultural futures contracts.

**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 Upland Cotton 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.

**Current Status of Cotton Contract**

In ACSA's testimony to the General Farm Commodities & Risk Management Subcommittee on May 15th, we reviewed the consequences to the price run-up in the ICE No. 2 Contract in the period from mid-February to early March and the resulting problems to the cotton industry due to an unrealistically widened basis pre-

cluding the use of the No. 2 Contract as a prudent hedging or risk management tool by producers, cooperatives, merchants, and mills.

I am pleased to report, that while the industry is still suffering from the repercussions of the disruptive market events of early March, the ICE has listened to the cotton industry and has agreed to make our recommended changes to margin the futures to futures settlements and options to option settlements. It has also agreed to the industry's proposal regarding the expansion of trading limits. These important changes should provide the necessary certainty to our financing banks, who had been reluctant to finance margin requirements under the previous system that established margins not at the closing price of the futures month, but at the "synthetic" level of the closing price of the options month, which added on additional financial exposure.

The CFTC, while focusing mostly on the monitoring of the energy markets, has launched a comprehensive investigation of the February–March trading in the cotton futures contract. We have limited knowledge of the investigation, but based on what we know, the CFTC's Enforcement Division has detailed a top-flight team to this important task. The Commission is also developing a proposal to require "more detailed reporting from index traders and swaps dealers . . . and to review whether classification of these types of traders can be improved for regulatory and reporting purposes." I might add that it was not possible for the Commission to effectively regulate the futures markets because it had never used its authority to request such information. The lesson is that lacking the appropriate information the markets cannot be properly monitored.

More importantly, the CFTC has also agreed to "review the trading practices for index traders . . . to insure that this type of trading activity is not adversely impacting the price discovery process, and to determine whether different practices should be employed."

The CFTC Agricultural Advisory Committee is scheduled to meet on July 29th Mr. Gillen and I have served as members of that Committee. At that meeting, we expect to discuss a myriad of proposals on what can and should be done to assure that the agricultural futures markets function as Congress intended that they should.

**Hedge Exemptions—Speculative Position Limits**

In our earlier testimony we discussed the recent phenomena of the participation of the index funds and the over-the-counter traders, who have flooded the futures markets with record liquidity to the extent that the resulting widened basis has in fact made the markets illiquid to those for whom Congress created these markets. This has had the effect of rendering the markets, particularly the cotton contract, which has significantly different supply/demand fundamentals than the other agricultural commodities, ineffective for hedging against price risks and discovering prices. More importantly, this has adversely impacted the physical markets since merchants or cooperatives cannot offer price quotations to farmers or end-users because they cannot use the contracts for hedging purposes.

Simply put, these markets, now overrun by cash, preclude the convergence of cash and futures prices, hedging, and forward contracting. The markets now lack the economic purpose that the Congress required when it originally authorized the trading of agricultural futures contracts.

**Speculative Position Limits**

The Congress through the CFTC has imposed speculative positions limits in the futures contracts to reduce the potential for market disruption or manipulation. But such limits are no longer effective for two reasons, first, the CFTC has granted hedge exemptions to the investment funds allowing them to exceed the limits, and second, large traders were permitted by the Congress, through the swaps exemption, to operate outside the regulatory framework through the swaps markets. The transactions in these hidden markets are permitted to take place off-exchange where each party mutually agrees to satisfy each other's credit standards and to remit margins to one another as the underlying market fluctuates. Such transactions have the characteristics of an exchange-traded futures contract, but are traded "over-the-counter" (OTC) and are not subject to CFTC oversight.

Such transactions pose problems when one of the parties to the swap has a "hedge exemption" that exempts his on-exchange futures trading from position-size limits. The swaps dealer would take an equal and opposite position in the futures market to the swaps trade. For example, should a pension fund desire to purchase $20 million in long exposure in cotton, it can purchase this exposure from a swaps dealer. The dealer, now short the price of cotton via the swap, enters the futures market to hedge his position by buying cotton futures. Given that he is a "hedger," CFTC

allows him to trade futures in excess of the normal speculative position-size limits. This has created a situation where such large investors can trade in any contract in any size they desire without regard to position limits. They are not limited by the CFTC. Only a swaps dealer can limit such trades, and no swaps dealer is going to turn a deaf ear to any financial entity awash in cash.

These arrangements, along with the billions of dollars invested in index funds, bring so much cash into a market that the traditional speculators cannot take a short position to match the institutional longs. This leaves it up to the commercials—cooperatives, the merchants, and the processors to offset these positions. But lacking the huge margin requirements they cannot do so. That is the situation today as the funds continue to purchase futures. Unwilling to assume such margin risks in such a volatile futures market the commercials remain passive not only in the futures, but in the physical markets. The result—markets with no economic purpose for the commercials. Therefore, no business is done. Producers, lacking a price, cannot properly plan and processors must buy hand to mouth. Simply put, the investment funds have negated the real purpose of the futures markets causing severe disruptions in the agricultural marketing process.

**Recommendations**

While we are pleased that the CFTC has placed a moratorium on granting further hedge exemptions to the so-called "passive" investment funds, action must be taken—a balance must be struck—with those funds currently operating with a hedge exemption.

We submit that the CFTC should take immediate action to require **that an index fund with a hedge exemption restrict its position in a commodity to the donor 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.**

ACSA also recommends **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, ETF's, swaps, OTC, and other trading entities.**

We also recommend that the CFTC **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.** It is also recommended **that only those involved in the commercial enterprise of physically trading bales of cotton, shall be eligible for hedge margin levels.**

In our view, these requirements would provide the CFTC and the trading public with the necessary information on which to make sound regulatory and market decisions. It will hopefully attenuate the current situation in which these essential markets have become investment vehicles for speculative funds who act unimpeded by market fundamentals or regulation.

Again, Mr. Chairman, thank you for providing us with the opportunity to participate in these important hearings and for your attention to our concerns.

The CHAIRMAN. Thank you.

Mr. White, welcome.

## STATEMENT OF ADAM K. WHITE, C.F.A., DIRECTOR OF RESEARCH, WHITE KNIGHT RESEARCH & TRADING, ALPHARETTA, GA

Mr. WHITE. Thank you. Mr. Chairman and Members of the Committee, thank you for the opportunity to share my research on the threat to the U.S. economy from excessive speculation.

Erosion and elimination of speculative position limits has allowed hundreds of billions of dollars of speculative money to flow into the commodity futures markets, causing food and fuel prices to skyrocket. This has damaged the price discovery function by pushing prices far and beyond what supply and demand would dictate.

Commodity futures markets are a unique hybrid form of marketplace with two distinctly different types of market participants.

When physical hedgers are the dominant force, then futures prices will accurately reflect the real world supply and demand fundamentals that these hedgers are experiencing directly in their own businesses. When speculators are the dominant force, then futures prices often become untethered from supply and demand and can reach irrationally exuberant heights.

Today the agricultural and energy markets rely on the futures prices as their benchmark for the pricing of nearly all of their transactions to the real world spot markets. For many commodities, when the nearby futures price rises by a dollar, spot price rises by a dollar as well. In the last 5 years, a titanic wave of speculative money has flowed into the commodity futures markets and dramatically driven up both futures and spot prices. Institutional investors have come to view commodity futures as an investable asset class, giving birth to a new form of speculator. I call them index speculators.

The first slide shows assets allocated to commodity index trading strategies have risen twenty-fold from $13 billion in 2003, to $260 billion in March of 2008, and the prices of the 25 commodities that compose these indexes have risen by an average of 183 percent.

The second slide shows that the commodities futures markets are small markets. In 2004, their total size was only $180 billion. And over the next 5 years, as hundreds of billions of dollars flowed into these markets, caused futures prices to rise dramatically as the markets were forced to expand and absorb this influx of money. Index speculators have bought more commodities futures contracts in the last 5 years than any other group of market participants. They are now the dominant force in the commodities futures markets. And worst of all, their buying has little to do with the supply and demand fundamentals of any single commodity.

Since 85 percent of index speculators enter into commodity swaps, these swap dealers have huge futures positions. Recently released data shows that swaps dealers as a category are the largest holders of NYMEX WTI crude oil futures contracts. This slide shows that as their positions have grown, so has the price of oil.

Now, I am not a legal expert, but I believe there are three key elements that need to be part of whatever legislation Congress does adopt. First, there need to be Federal speculative position limits for all U.S.-based commodities across all exchanges.

In 1936, Congress established speculative position limits in order to ensure the dominance of physical hedgers and to prevent speculative bubbles from forming. However, over the years, these position limits have been raised or eliminated. I recommend that a panel of physical hedgers be convened to establish real, meaningful position limits, since they will set limits that truly restrict speculation without restricting necessary liquidity.

Second, speculative position limits must apply in the over-the-counter commodity swaps market. Excluding swaps from position limits would allow excessive speculation to continue unabated and render existing limits meaningless.

Finally, the practice of commodity index speculation should be prohibited because of the liquidity it consumes and the damage it does to the price discovery function. Speculative position limits worked well for over 50 years and carry no unintended con-

sequences. If Congress takes these actions, then the speculative money that flow to these markets would be forced to flow out. And with that, the price of commodities would come down substantially. Until speculative position limits are restored, investor money will continue to flow unimpeded into commodity markets and prices will continue to rise.

Thank you.

[The prepared statement of Mr. White follows:]

PREPARED STATEMENT OF ADAM K. WHITE, C.F.A., DIRECTOR OF RESEARCH, WHITE KNIGHT RESEARCH & TRADING, ALPHARETTA, GA

Mr. Chairman and Members of the Committee, thank you for the invitation to speak to you today. I first began to study the role of institutional investment in the commodities futures markets, back in early 2006, while I was employed by Masters Capital Management. Since I formed my own independent research company I have continued to study this issue in-depth. I have recently added the Air Transport Association as a client but I am not representing them here today.

Instead I want to share the results of my research efforts. I am co-authoring an in-depth research report with Michael Masters that we hope to have completed in the next week or 2. My testimony today essentially represents the executive summary of that report. With your permission I would like to submit the full report to your Committee when it is complete. [i]

The commodities futures markets are a unique hybrid form of marketplace where two distinctly different categories of market participants transact side by side. Physical Hedgers access the markets to reduce the price risk of their underlying physical commodity businesses, while Speculators trade in the markets to make maximum profits.

When Physical Hedgers are the dominant force in the marketplace then futures prices will accurately reflect the real world supply and demand fundamentals these physical consumers and producers are experiencing directly in their businesses. When Speculators are the dominant force, then futures prices often become un-tethered from supply and demand and can reach irrationally exuberant heights.

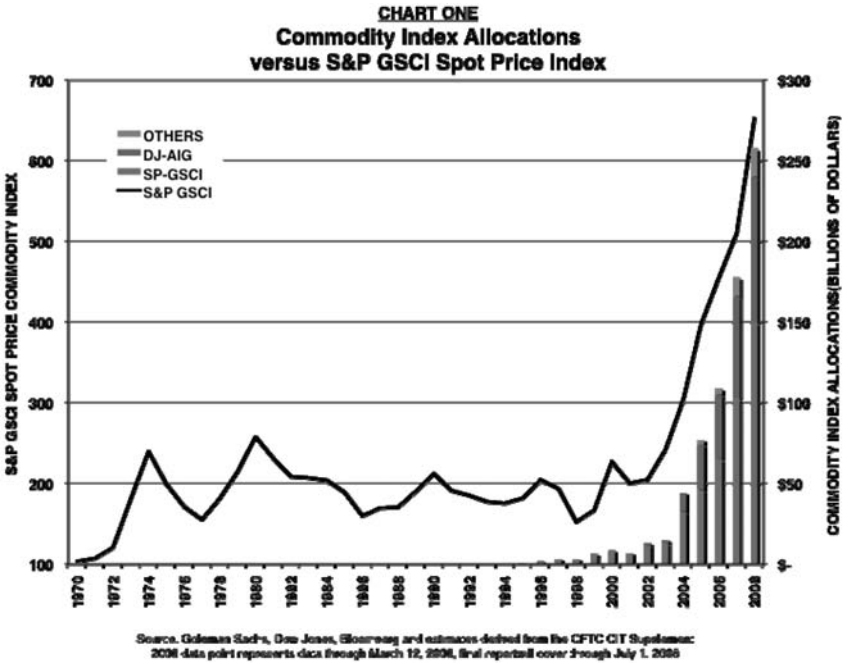
In 1936 Congress devised a system whereby speculative position limits would restrict the size of Speculators' positions in order to ensure the dominance of *Bona Fide* Physical Hedgers and to prevent speculative bubbles from forming. [ii] Congress took this action because they realized that the commodities futures markets were essential to the health of the American economy.

Today the agricultural and energy markets rely on the futures price as their benchmark for the pricing of nearly all their transactions in the real world "spot" markets. [iii] For many commodities, when the nearby futures price rises by $1, the spot price rises by $1 as well. This is preferred by Physical Hedgers because they can use the futures markets to hedge their price risk on a dollar for dollar basis.

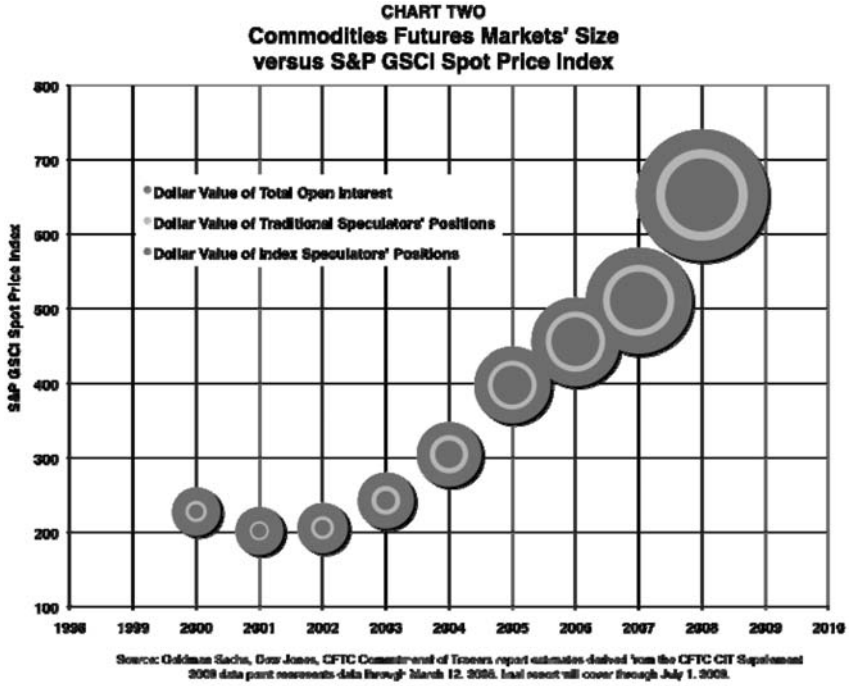
Unfortunately the price discovery function of the commodities futures markets is breaking down. With the advent of financial futures the important distinctions between commodities futures and financial futures were lost to regulators. The term excessive speculation effectively came to mean manipulation. [iv] Therefore speculative position limits were raised or eliminated because they were not deemed necessary for the prevention of manipulation. [v]

Swaps dealers who trade derivatives in the completely unregulated over-the-counter markets were given the same virtually unlimited access to the futures markets that *Bona Fide* Physical Hedgers enjoy. These swaps dealers turned around and convinced institutional investors that commodities futures were an asset class that would deliver "equity-like returns" while reducing overall portfolio risk. These investors were encouraged to make "a broadly diversified, long only passive investment" in commodities futures indices. [vi] And as a result a new and more damaging form of speculator was born—I call them Index Speculators.

As *Chart One* below demonstrates the result has been a titanic wave of speculative money that has flowed into the commodities futures markets and driven up prices dramatically. Assets allocated to commodity index trading strategies have risen from $13 billion at the end of 2003 to $260 billion as of March 2008, [vii] and the prices of the 25 commodities that compose these indices have risen by an average of 183% in those 5 years! [viii]

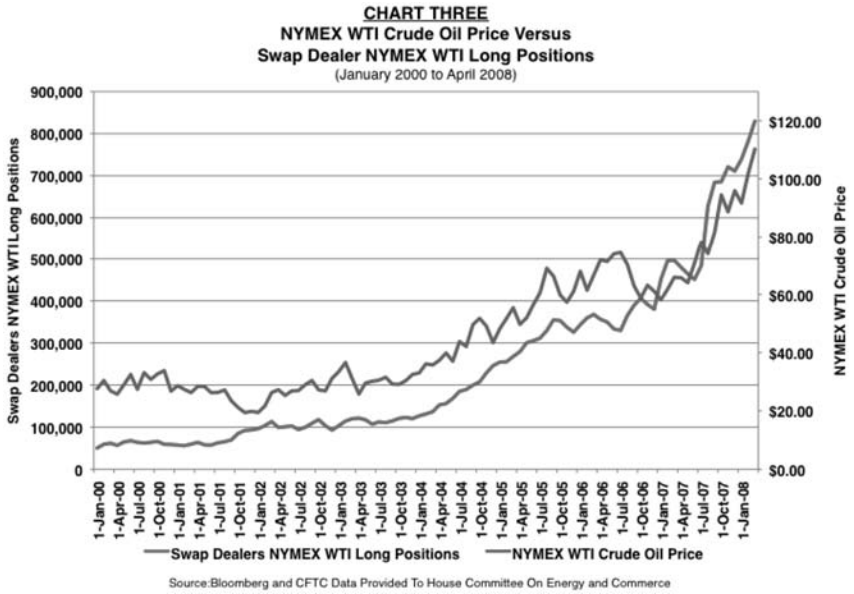



The total open interest of the 25 largest and most important commodities, upon which the indices are based, was $180 billion in 2004. [ix] From the beginning of 2004 to today, Index Speculators poured $167 billion into these 25 commodities. [x] As *Chart Two* below shows this has caused futures prices to rise dramatically as the commodities futures markets were forced to expand in order to absorb this influx of money.




Index Speculators have bought more commodities futures contracts in the last 5 years than any other group of market participant. [xi] They are now the single most dominant force in the commodities futures markets. [xii] And worst of all their buying has nothing to do with the supply and demand fundamentals of any single commodity. They pour money into commodities futures to diversify their portfolio, hedge against inflation or bet against the dollar. It is likely that they cannot even name the 25 commodities that exist in the indices.

The four largest commodity swaps dealers: Goldman Sachs, Morgan Stanley, J.P. Morgan and Barclays Bank are reported to control 70% of the commodity index swaps positions. [xiii] That would mean that on average about one out of every four long positions on the exchanges is controlled by one of these banks. [xiv] Recently released data from the House Energy Committee shows that swaps dealers as a category have grown to become the largest holders of NYMEX WTI crude oil futures contracts. [xv] *Chart Three* on the next page shows that as their positions have grown in size so has the price of oil.




I am not a legal expert so I cannot comment specifically about each of the proposed pieces of legislation currently pending in the House and the Senate but I believe there are several key elements that need to be part of whatever legislation Congress does adopt.

First there needs to be Federal speculative position limits for all commodities (except precious metals). These limits need to apply in aggregate across all exchanges trading U.S. based futures contracts. I recommend that a panel of *Bona Fide* Physical Hedgers be convened to determine these position limits since they can be relied upon to set them at levels that truly restrict speculation without restricting necessary liquidity.

Second, speculative position limits must apply in the over-the-counter (OTC) commodity swaps market. The commodity swaps market does not need to be regulated per se but if swaps dealers want to access the futures markets then they must report all their counterparties' positions in order to ensure that no one is in violation of speculative position limits. The OTC swaps market is many times bigger than the futures markets so excluding swaps from position limits would allow excessive speculation to continue unabated and render existing limits meaningless.

Third, excessive speculation should be numerically defined as a percentage of open interest. The same panel of *bona fide* physical hedgers should also determine this figure. Then the CFTC can establish a system whereby the individual position limits adjust based on the overall level of speculation in the marketplace. This system would prevent the commodities futures markets from ever reaching a level of excessive speculation in the future.

Finally the practice of commodity index replication should be prohibited. Index Speculators damage the price discovery function and lock up large amounts of market liquidity by buying and holding futures positions for the ultra long term. Congress would not allow someone to hoard physical commodities so they should not allow institutional investors to hoard commodities futures either. A way should be found to prevent this damaging practice from continuing.

Speculative position limits worked well for over 50 years and carry no unintended consequences. If Congress takes these actions then the speculative money that flowed into these markets would be forced to flow out and with that the price of commodities futures would come down substantially. Until speculative position limits are restored investor money will continue to flow unimpeded into the commodities futures markets and prices will continue to rise.

**Endnotes**

[i] All of the data in my testimony today is calculated as of March 2008. When I submit the completed report the data will be updated through July 1, 2008.

[ii] "The fundamental purpose of the measure is to insure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity which too often demoralize the markets to the injury of producers and consumers and the exchanges themselves." Report No. 421, U.S. House of Representatives 74th Congress, Accompanying the Commodity Exchange Act, March 18, 1935.

"It should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations." President Franklin D. Roosevelt message to Congress February 9, 1934

"The bill authorizes the Commission . . . to fix limitations upon purely speculative trades and commitments. Hedging transactions are expressly exempted. That this power of the Commission will be exercised judiciously and for the purposes merely of preventing overspeculation and a type of 'racketeering' by a few large professional traders, may be assumed as a matter of course." Report No. 421, U.S. House of Representatives 74th Congress, Accompanying the Commodity Exchange Act, March 18, 1935.

[iii] "In many physical commodities (especially agricultural commodities), cash market participants base spot and forward prices on the futures prices that are 'discovered' in the competitive, open auction market of a futures exchange." "The Economic Purpose of Futures Markets and How They Work—Price Discovery or Price Basing," Commodities Futures Trading Commission website, *http://www.cftc.gov/educationcenter/economicpurpose.html.*

"In the spot market, therefore, negotiations for physical oils will typically use NYMEX as a reference point, with bids/offers and deals expressed as a differential to the futures price. Using these differentials, Platts makes daily and in some cases intra-day assessments of the price for various physical grades of crude oil, which may be referenced in other spot, term or derivatives deals." "Platts Oil Pricing and Market-on-Close Methodology Explained—A Backgrounder," Platts, A Division of McGraw Hill Companies, July 2007, page 3. *http://www.platts.com/Resources/whitepapers/index.xml.*

[iv] "Excessive Speculation" (7 U.S.C. 6a) and "Manipulation" (7 U.S.C. 13b) are separate sections of the Commodity Exchange Act. Excessive Speculation is remedied by establishing speculative position limits and is not a violation of the Act. Manipulation is a violation and can result in monetary penalties and jail time. Yet on the CFTC website it says "In general, position limits are not needed for markets where the threat of market manipulation is non-existent or very low." *http://www.cftc.gov/industryoversight/marketsurveillance/speculativelimits.html#P8_883.*

So their stance appears to be that position limits exist to prevent manipulation. Contrast this with the comments of Johnson and Hazen in their book "Derivatives Regulation" where they say "However, Section 4a (7 U.S.C. 6a) is expressly concerned with 'excessive speculation' and thus is not specifically an anti(-)manipulation provision. Rather, section 4a focuses upon market disorders attributable to unbridled speculative activity, without regard to whether that speculative frenzy has a manipulative purpose." Section 5.02[1] "Derivatives Regulation," Philip McBride Johnson and Thomas Lee Hazen, Aspen Press, 2004, page 1235.

[v] "In general, position limits are not needed for markets where the threat of market manipulation is non-existent or very low. . . . A contract market may impose for position accountability provisions *in lieu of* position limits for contracts on . . . certain tangible commodities, which have large open interest, high daily trading volumes, and liquid cash markets." *http://www.cftc.gov/industryoversight/marketsurveillance/speculativelimits.html#P8_883.*

In 1998 the CFTC allowed the futures exchanges such as the NYMEX to replace "speculative position limits" with "position accountability limits" which do not actually limit the size of positions but simply represent a threshold above which the exchanges look closer at positions to ensure that manipulation is not occurring. The result is that NYMEX WTI crude oil does not have any speculative position limits except in the last 3 days prior to expiration. 63 FR 38525 (July 17, 1998) *http://www.cftc.gov/foia/comment98/foi98--028_1.htm.*

[vi] "Investing and Trading in the GSCI," Goldman, Sachs & Co., June 1, 2005.

[vii] "Investing and Trading in the GSCI," Goldman, Sachs & Co., June 1, 2005, CFTC Commitments of Traders Report—CIT Supplement and estimates derived there from.

[vii]

Commodity Futures Prices

March 2003–March 2008

| | | |
|---|---|---|
| *Agricultural:* | | |
| Cocoa | + | 34% |
| Coffee | + | 167% |
| Corn | + | 134% |
| Cotton | + | 40% |
| Soybean Oil | + | 199% |
| Soybeans | + | 143% |
| Sugar | + | 69% |
| Wheat | + | 314% |
| Wheat KC | + | 276% |
| *Livestock:* | | |
| Feed Cattle | + | 34% |
| Lean Hogs | + | 10% |
| Live Cattle | + | 23% |
| *Energy:* | | |
| Brent Crude Oil | + | 213% |
| WTI Crude Oil | + | 191% |
| Gasoil | + | 192% |
| Heating Oil | + | 192% |
| Gasoline | + | 145% |
| Natural Gas | + | 71% |
| *Base Metals:* | | |
| Aluminum | + | 120% |
| Lead | + | 564% |
| Nickel | + | 282% |
| Zinc | + | 225% |
| Copper | + | 413% |
| *Precious Metals:* | | |
| Gold | + | 183% |
| Silver | + | 331% |

Source: Bloomberg

[ix] Bloomberg did not have open interest data for the base metals in 2004 so I used 2005 figures for 2004. This is conservative since prices were rising during this time frame.

Average Daily Dollar Value of Open Interest in 2004

(millions)

| | |
|---|---|
| Cocoa | $1,569 |
| Coffee | $2,748 |
| Lean Hogs | $1,873 |
| Live Cattle | $3,556 |
| Brent Crude | $12,620 |
| WTI Crude | $33,620 |
| Gasoil | $5,461 |
| Heating Oil | $8,242 |
| Gasoline | $7,304 |
| Natural Gas | $25,897 |
| Aluminum | $12,286 |
| Lead | $677 |
| Nickel | $1,986 |
| Zinc | $2,696 |
| Copper | $11,864 |
| Gold | $13,221 |
| Silver | $3,745 |
| Total | $179,590 |

Source: Bloomberg

[x] There is no publicly available data that shows the total amount of inflows into commodity indexation trading strategies but some approximations can be made. The

total amount benchmarked to the S&P-GSCI and DJ–AIG can be estimated and the annual performance of the indices is known. Therefore the amount that the prior year's investment has grown or shrunk can be computed. Then the difference in the yearly change has to come from net inflows. When during the year the inflows occurred is not known, so the assumption is made that all net inflows occurred evenly throughout the year. Changing assumptions on net inflow timing only affects the rate of growth for that year's inflow which never amounts to more than a few billion dollars difference.

Estimated Annual Inflows

| | S&P–GSCI | DJ–AIG | Total |
|---|---|---|---|
| 2004 | $16.20 | $8.90 | $25.10 |
| 2005 | $4.80 | $12.40 | $17.20 |
| 2006 | $28.30 | $11.30 | $39.60 |
| 2007 | $14.70 | $15.40 | $30.10 |
| 2008 | $35.10 | $20.00 | $55.10 |
| Total | $99.10 | $68.00 | $167.10 |

2008 figures reflect estimated inflows through March 12, 2008, figures will be updated through July 1, 2008 with final report.

[xi]

| | 2003 Long Open Interest | | |
|---|---|---|---|
| | Physical Hedger | Traditional Speculator | Index Speculator |
| Cocoa | 71,300 | 5,673 | 2,710 |
| Coffee | 38,378 | 12,197 | 5,671 |
| Corn | 227,612 | 54,123 | 51,139 |
| Cotton | 52,529 | 23,633 | 9,518 |
| Soybean Oil | 76,717 | 33,449 | 3,272 |
| Soybeans | 98,696 | 58,567 | 13,733 |
| Live Cattle | 19,820 | 40,864 | 20,021 |
| WTI Crude Oil | 433,028 | 56,629 | 108,599 |
| Heating Oil | 69,363 | 14,063 | 26,217 |
| Gasoline | 44,252 | 20,698 | 25,555 |
| Natural Gas | 397,488 | 21,734 | 29,774 |
| Total | 1,691,579 | 416,042 | 404,785 |
| | 2008 Long Open Interest | | |
| Cocoa | 50,243 | 72,866 | 29,527 |
| Coffee | 41,159 | 56,866 | 63,133 |
| Corn | 505,627 | 300,017 | 441,197 |
| Cotton | 91,820 | 77,132 | 114,804 |
| Soybean Oil | 104,064 | 48,619 | 72,287 |
| Soybeans | 141,375 | 132,849 | 194,391 |
| Sugar | 359,427 | 180,670 | 411,510 |
| Wheat | 58,484 | 66,958 | 218,191 |
| Wheat KC | 35,629 | 31,201 | 30,299 |
| Feeder Cattle | 5,117 | 16,208 | 9,279 |
| Lean Hogs | 29,366 | 33,374 | 105,228 |
| Live Cattle | 27,898 | 51,798 | 135,451 |
| WTI Crude Oil | 1,161,063 | 203,280 | 606,176 |
| Heating Oil | 65,851 | 27,972 | 83,008 |
| Gasoline | 83,826 | 41,534 | 78,692 |
| Natural Gas | 480,964 | 77,462 | 214,641 |
| Total | 3,241,915 | 1,418,805 | 2,807,813 |
| | Purchases Last 5 Years | | |

| | 2003 Long Open Interest | | |
|---|---|---|---|
| | Physical Hedger | Traditional Speculator | Index Speculator |
| Cocoa | −21,056 | 67,193 | 26,817 |
| Coffee | 2,781 | 44,669 | 57,463 |
| Corn | 278,016 | 245,894 | 390,057 |
| Cotton | 39,291 | 53,499 | 105,286 |
| Soybean Oil | 27,348 | 15,169 | 69,015 |
| Soybeans | 42,679 | 74,282 | 180,658 |
| Sugar | 263,817 | 149,527 | 365,579 |
| Wheat | 33,639 | 41,260 | 184,231 |
| Wheat KC | 2,870 | 26,246 | 19,773 |
| Feeder Cattle | 1,253 | 10,969 | 6,637 |
| Lean Hogs | 24,049 | 25,997 | 89,711 |
| Live Cattle | 8,078 | 10,934 | 115,429 |
| WTI Crude Oil | 728,035 | 146,651 | 497,577 |
| Heating Oil | −3,512 | 13,909 | 56,791 |
| Gasoline | 39,574 | 20,836 | 53,137 |
| Natural Gas | 83,476 | 55,728 | 184,867 |
| Total | 1,550,337 | 1,002,764 | 2,403,029 |

Figures derived from data from Goldman Sachs, Dow Jones, Bloomberg, CFTC Commitments of Traders report and the CFTC CIT Supplement. Non-Directional Spreads and Non-Report (Unclassified) Positions are not shown. Traditional Speculators accessing the futures market through the "swaps loophole" are still classified as Physical Hedgers because the CFTC does not distinguish. 2008 figures are as of March 12, 2008 and will be updated to reflect July 1, 2008 in the final report.

[xii]

Commodities Futures Markets

Percentage of Open Interest

2008 Long/Demand Side

| | Physical Hedger | Traditional Speculator | Index Speculator |
|---|---|---|---|
| Cocoa | 33% | 48% | 19% |
| Coffee | 26% | 35% | 39% |
| Corn | 41% | 24% | 35% |
| Cotton | 32% | 27% | 41% |
| Soybean Oil | 46% | 22% | 32% |
| Soybeans | 30% | 28% | 42% |
| Sugar | 38% | 19% | 43% |
| Wheat | 17% | 20% | 64% |
| Wheat KC | 37% | 32% | 31% |
| Feed Cattle | 17% | 53% | 30% |
| Lean Hogs | 18% | 20% | 63% |
| Live Cattle | 13% | 24% | 63% |
| WTI Crude Oil | 59% | 10% | 31% |
| Heating Oil | 37% | 16% | 47% |
| Gasoline | 41% | 20% | 39% |
| Natural Gas | 62% | 10% | 28% |
| Average | 34% | 26% | 40% |

Source: CFTC Commitments of Traders reports, and estimates derived from CFTC CIT Supplement, does not include Spreads.

Data represents an average from January 1, 2008 through March 12, 2008, data in final report will reflect through July 1, 2008

[xiii] "The Global Commodities Boom," Greenwich Associates, Andrew Awad, Woody Canaday, et al., May 2008, page 1. "Commodities: Who's Behind the Boom?,"

Gene Epstein, *Barron's,* March 31, 2008. First report identifies the four largest swaps traders and second article references some ISDA data saying four largest swaps traders are 70% of swaps market. Barron's also says and CFTC CIT supplement corroborates that 85%–90% of all index trades are done through swaps.

[xiv] According to calculations Index Speculators average 40% of the long open interest (excluding spreads) in U.S. based commodities (see footnote [xii]), 85–90% is done through swaps and 70% of swaps are done with the four largest traders. So .7*.875*.4=.245 or 24.5%. I cannot know for sure if this estimate is accurate since I do not have access to this information.

[xv] *http://energycommerce.house.gov/Investigations/EnergySpec.shtml.*

The CHAIRMAN. Thank you all for your testimony.

Mr. Nicosia, in your testimony here, you are saying something about the hedge exemption should be restricted to the dollar allocation of the percentage of funds of the index. Is that not what they are doing now? Do they get an exemption for the whole amount of the fund but it is not done by commodity, or what are you talking about there?

Mr. NICOSIA. No. It is in their prospectus, they usually show what percentage they are going to allocate to different commodities. Our concern is that under the umbrella of a hedge exemption, that they use discretionary trading which is not passive. So as opposed to an index fund which is going to allocate a certain dollar amount to an individual commodity, have it invested and leave it there, the record, especially in cotton, shows that they have not done that. As leading up to the debacle that we had on March 3rd and 4th, where prices rose 11 limits in about 90 minutes, you can see that the index position was very aggressive in the 2 weeks leading up to that and then actually liquidated. In that particular case, I doubt that the index funds had a 16 percent increase in their allocation of money and then a ten percent decrease within a week of their money. We know that the money continued to flow in all through that time.

The CHAIRMAN. So they had some information and they went in and they——

Mr. NICOSIA. In other words, they didn't act as a passive investor. In other words, they were using their hedge exemptions to act as an extended arm of the regular discretionary trader.

The CHAIRMAN. But I was told that most of these index funds don't even put the money in the market.

Mr. NICOSIA. Yes, I heard that earlier today. There was a lot of disinformation you received from the other panels. That is not true. There is massive amounts of index participation directly into the futures market. So much so that there are even funds that have been set up to counteract fund rolls that exist from days 5 through 9 when they start to roll their futures. There is massive participation.

The CHAIRMAN. Do you have any idea what the percentage is?

Mr. NICOSIA. I found it interesting too that on the energy side, although I am not an energy expert, the reports that people have been using to try to gauge, whether it be speculator involvement, the energy markets do not report on the Commitment of Traders reports as they do in the ags. So it is impossible to gauge that. Index funds, swap dealers are all listed as hedgers on the energy markets. Therefore, the subset is not divided out. So they are acting as if the speculative community number may not be changing greatly, because the number that would be added to it is hidden

within the hedger number. You don't even see it. In the agricultural commodity markets, however, from the pilot program, CFTC does in fact break it out. For example, in soybeans, if you took the noncommercial long and the index trader today, they are long 50 percent of the entire United States crop speculatively. Now, for someone to say that has no impact in price I think would be fairly foolish. Today the speculative position in corn equals over 2.15 percent of the amount of the total carryout that exists in the United States at the end of the year. And if you look at it as a percentage of open interest, 40 percent of the entire open interest in soybeans is owned by the speculative position, 35 percent in cotton. So the agricultural markets do have the information split out from index funds. Energy markets do not.

The CHAIRMAN. But we don't know what percentage of this is index funds out of the whole money that is flowing into the——

Mr. NICOSIA. We know that from the reports in agriculture, absolutely.

The CHAIRMAN. But we don't know it in energy?

Mr. NICOSIA. CFTC does not require that to be split out. They did the pilot program. They only did it for agriculture.

The CHAIRMAN. Mr. White, that is how you tried to figure it out. You took these numbers out of agriculture and extrapolated based on how they are structured in these index and try to figure out how much was oil, right? Is that what you told me?

Mr. WHITE. Yes, that is exactly right. And I didn't invent that, but many have done the same thing.

The CHAIRMAN. Surely none of you think that we should decide what they should be. Is there anybody that thinks that the Congress should decide what the position limits are?

Mr. MARSHALL. Mr. Chairman?

The CHAIRMAN. What? Do you think we should?

Mr. MARSHALL. No. There is another entity that could. It is the CFTC, the CFTC I am pretty sure——

The CHAIRMAN. Go ahead.

Mr. MARSHALL. If I could. You are getting at the fact that CFTC sets these limits not the exchanges?

The CHAIRMAN. No, no. I was trying to figure out what is going on here. You are probably way beyond where I am at.

Mr. NICOSIA. Mr. Chairman, if I could. Position limits today are really pretty much a joke because there is no way to enforce them because you can just circumvent them easily off the exchange.

The CHAIRMAN. Even on the ag?

Mr. NICOSIA. Even on the ags because—the swap situation is not subject to those limits. And the only ones that are required to report the swaps are actually the traditional hedgers, the commercial hedgers who are in there. We actually do have to report all of that information as part of a cash transaction. But anyone who wants to exceed the limits can do so very easily.

The CHAIRMAN. So was it you that recommended that you get a bunch of people that are involved together and figure out what these limits are? Was that you? Or was that you, Mr. White? I was told by somebody that in the ag area, they get the people together that are involved in this and they are the ones that decide what these limits are. Is that true? Is that how that works? I mean, does

the CFTC do that? Do they get these people to recommend and they set these limits; how does that work?

Mr. NICOSIA. It does work in conjunction through the exchange as well as through CFTC. I was a long-term Board Member for the New York Cotton Exchange in the New York Board of Trade. And the process that took place there is often the CFTC would actually make recommendations back to us for the size of position limits. They would often do that as a percentage maybe of open interest or of trading volume or in relationship to other markets. There are times that maybe the exchange could also request of the CFTC an increase that took place. Often at those points in time, many of the contract committees in agriculture would have some response. At the New York Board of Trade, the Board and the contract committees and/or the trade were very involved in either okaying or not okaying those speculative limits. The exchange also had the right to accept those limits or lower ones.

The CHAIRMAN. Okay. So that process does go on in all the agriculture area?

Mr. NICOSIA. Yes.

The CHAIRMAN. And so who actually has the power to do this, the exchange or the CFTC?

Mr. NICOSIA. CFTC.

The CHAIRMAN. So in the end they could set the limits wherever they want?

Mr. NICOSIA. Yes.

The CHAIRMAN. Now in oil, does that happen? Is there anybody, any process like that to set limits in oil?

Dr. NEWSOME. Yes, sir, there are not federally mandated limits in energy, but there are guidelines in the Commodity Exchange Act that say that limits should not be set any higher than what would roughly be 25 percent of the underlying deliverable of whatever commodity we are talking about. The NYMEX position limits are set conservative as compared to those guidelines, and the CFTC is involved in every step of the discussion with NYMEX to determine what the appropriate limits would be.

The CHAIRMAN. And in that case, does the CFTC in the end have the final say or do you guys?

Dr. NEWSOME. The exchange has the final say——

The CHAIRMAN. It is different than agriculture?

Dr. NEWSOME. It is different than agriculture, yes.

The CHAIRMAN. And what would your position be if we changed that so it is like agriculture?

Dr. NEWSOME. Well, I mean, first of all, we don't believe that the position limits have been abused in the energy sector on the regulated exchanges. And we like the flexibility created of having a dialogue with the CFTC, based upon the guidelines that are in the Commodity Exchange Act. Have we ever disagreed with the CFTC at the end of the day? No. They are a Federal regulator. But we do like having the flexibility and the dialogue with them.

The CHAIRMAN. So you don't think there is a problem with the position limits?

Dr. NEWSOME. Certainly not at the NYMEX, no, sir.

The CHAIRMAN. Mr. White.

Mr. WHITE. I think it is important to point out that position limits at NYMEX and WTI crude oil, my understanding has only existed in the last 3 days of trading.

The CHAIRMAN. Suppose the index and swaps are out before the last 3 days anyway.

Mr. WHITE. That is right. So they are having their impact in months other than the last 3 days.

The CHAIRMAN. Why is it set for the last 3 days, Jim? Can you tell us that?

Dr. NEWSOME. Yes, sir. We have position accountability across all months. And then we have the hard limits within the last 3 days for both commercials and for speculative traders. And the reason that the 3 days are important is that is when the price is determined that the whole industry uses. And when that final price is determined, which is the key price discovery component, then the speculators are either completely decreased or out of the market.

The CHAIRMAN. The gentleman from North Carolina.

Mr. ETHERIDGE. How long has that been in force?

Dr. NEWSOME. Roughly 20 years, Congressman.

Mr. ETHERIDGE. Thank you, Mr. Chairman. Since this topic is on hedge exemption and speculation position limits, let me run by you some numbers that we talked about yesterday. In 2006, 46 hedge exemptions were granted for West Texas Intermediate crude oil contracts traded on NYMEX, some of which lasted just 1 year and some for 1 month. In 2007, only 36 hedge exemptions were granted. In 2008, to date, only 11 exemptions have been granted. So as oil has climbed to almost $100 in 2007 and I don't know what it cleared out today, $135 plus, demand for hedge exemptions has declined. And when Mr. Stupak said that because some exemptions lasted for a year, all 117 exemptions granted for West Texas Intermediate crude from 2006 to today were in effect. Now, I am afraid that is just not quite totally accurate. But at no time between 2006 and now have 117 exemptions been in effect at the same time. I think that is correct.

Dr. NEWSOME. That is totally correct.

Mr. ETHERIDGE. So as the theory goes, if swap dealers are using hedge exemptions to lay off the risk of all arrangements they have with pension funds, index funds, *et cetera,* which everyone believes is pouring money into commodities, shouldn't we be seeing an increased need for swap exemptions instead of a decline?

Dr. NEWSOME. Well, certainly.

Mr. ETHERIDGE. I would like to hear from each one of you on that, a short answer.

Dr. NEWSOME. Certainly from the exchange standpoint, we are not the driver behind requests for exemptions. Those come from the participants. We handle those on a case-by-case basis. And they have to show the *bona fide* need for the exemption, whether they are a commercial producer or a swaps dealer who has assumed the risk of commercial entities and therefore needs the exemption.

Mr. NICOSIA. With all due respect, the number of those that are requested have nothing to do with it. The number means nothing. As you heard earlier, the size of any one individual can more than overwhelm 20——

Mr. ETHERIDGE. All the rest of them?

Mr. NICOSIA. Exactly. So it is really the total number of dollars that are involved, not the number of hedge exemptions that are important.

Mr. ETHERIDGE. So your recommendation would be dealing with the dollar number *versus*——

Mr. NICOSIA. It is much more important to deal with the dollar number of the size of the positions that are being taken place within the exemption.

Mr. WHITE. I don't know enough about the hedge exemptions to really know. It is one of those things that really sounds like the devil is in the details. But to me the only reason you need an exemption is in the last 3 days, because there aren't any limits other than the last 3 days.

Mr. ETHERIDGE. Okay. Comment?

The CHAIRMAN. Well, if you would yield.

Mr. ETHERIDGE. Yes.

The CHAIRMAN. Didn't you say there was some other kind of control before that?

Dr. NEWSOME. There are accountability limits that we use.

The CHAIRMAN. What does that mean?

Dr. NEWSOME. It means they are not hard limits, but they are limits that are put on by the exchange that cover the total limits that a participant can have across all months within that sector. So again these limits that are granted are not open ended. They represent only what that entity has shown that they have the need to truly hedge. And at the end of the day, based upon the CFTC guidelines, no more than 25 percent of the overall underlying deliverable can be exempted.

So, I mean, there are steps that we follow to make sure that what the concern that the Committee and others have does not exist on the regulated market. Now, I would be very quick to say that there are real differences between the agricultural markets and the energy markets. In terms of competitive exchanges there is a much, much larger over-the-counter marketplace within the energy sector. So I don't think what you say could hold true in ag necessarily holds true in energy.

Mr. ETHERIDGE. Mr. Nicosia, do you have this kind of information available for cotton?

Mr. NICOSIA. Yes, we do.

Mr. ETHERIDGE. Do you have that available just to share?

Mr. NICOSIA. I sure do.

Mr. ETHERIDGE. Would you make that available to the Committee Chairman?

Mr. NICOSIA. Absolutely. We have that and we also have the current status information for the main five ags as of this current week.

Mr. ETHERIDGE. Okay. I think that would be helpful to have.

Very quickly, Mr. White, we have heard the figure of $260 billion in index trading tossed around lately. But what you appear to be telling us today is that the $260 billion figure is just a snapshot of the value of the index funds and that in reality it is only $167 and new funds have been invested in commodities since 2004; is that correct?

Mr. WHITE. To be more specific, it was $13 billion in 2003. And then $167 billion in new money flowed in; the $13 billion from 2003, it grew; the $25 billion from 2004, it grew; the $167 billion is the amount of inflows; the $260 billion is the amount of the total today, in March.

Mr. ETHERIDGE. Okay. All right. Thank you. I appreciate that clarification.

Mr. Chairman, I yield back.

The CHAIRMAN. I thank the gentleman. The gentleman from Texas.

Mr. CONAWAY. Thank you, Mr. Chairman. I am struggling like you are to make sure I understand this. To me right now there is still a disconnect between an automatic assumption that volume and activity in the market is just the exact cause and effect to drive these prices higher. I have a great respect for Joe and Adam and others who are making that case. A little bit of Joe's background with cotton and what happened in March, I want to ask you about that in a second. I am still trying to understand this deal. Jim, you mentioned large trader data that needs to be—are there any implementation barriers to that? Is that something that could be done relatively easily by the various folks that would have to comply with that?

Dr. NEWSOME. It is a technical process that the IntercontinentalExchange, which is the foreign board of trade really in question here, has to implement. They are in the process of implementing that now. Even though they have supplied data in the past, it was not in the format that other exchanges supply and therefore not as readily available and usable for the CFTC. But they are working on supply and——

Mr. CONAWAY. Okay. Joe, you mentioned that in March, where the price limit was up 11 times over a very short period of time. Is that that the actual cash market was going up to catch up with the futures prices?

Mr. NICOSIA. The cash market never moved at all.

Mr. CONAWAY. Who got hurt in that regard?

Mr. NICOSIA. Everyone that was in the industry. The traditional hedger, the traditional user, the contract because what would be a traditional basis relationship between the cash and futures was totally divorced.

Mr. CONAWAY. But the folks who were long on those higher prices got hurt? Who got hurt?

Mr. NICOSIA. The person that got hurt was the person who had bought products from the farmer. When he buys product, he sells futures to hedge. So he has locked in a basis relationship.

Mr. CONAWAY. He is long on the product himself. This is a traditional hedger who is trying to hedge against his price?

Mr. NICOSIA. Exactly. So, long on the product and short in the futures. But what happens is that as the index fund and/or speculative community is allowed to buy futures totally unimpeded, they are able to stampede the price to levels that had nothing to do relative to the cash market. If a traditional hedger did what they did, we would go to jail because we are required to act in an economic fashion. When the cash becomes substantially cheaper than the futures, CFTC will not allow us to continue to buy futures because

they are saying we are acting in an noneconomic manner, and yet the index funds are allowed to do that as are speculators.

Now, the problem is that if someone is within their speculative limit, you can argue that there isn't anything wrong with that *per se*. But our contention is that amongst all these commodities, is that that would be fine if the CFTC could tell us that the aggregative positions from swaps, from the ETFs, from all the other sources were still within their speculative limits. Because today the exchanges do a reasonably good job in keeping people and watching speculative limits. It is what they don't see that they can't account for. CFTC also does not see it. And therefore if you want to take a position in excess of your speculative limit and/or to push prices improperly; you can do so, and, one, within the law; and, two, no one would even see it or monitor it.

Mr. CONAWAY. Later in your testimony you mentioned that you had a breakdown of all the ag participants in the deal and yet ag prices are up sharply. Are there other participants that are driving that? I mean, it seemed like your solution was greater transparency lets everybody know what all the positions are. And you said that was happening in ag. But yet if you look at ag, prices are up as sharply as oil, gas, or fuel prices.

Mr. NICOSIA. Right. And I think there is a very important difference you have to be able to draw. There is no doubt that supply and demand fundamentals and many of these commodities warrant a higher price. The question is whether that be crude oil at $110 instead of $145; or soybeans at $13 instead of $16; or whether wheat should have went to $17 *versus* $25. And there are certain rules that are laid down. Our biggest concern is that people play within the rules that they have because today there is absolutely no way to find that.

Mr. CONAWAY. On the overall position limits, is that for the entire commodity, the collective positions can only be 25 percent of 1 day's trading; or is that each individual participant has a certain amount they could hold? How does it mechanically work?

Dr. NEWSOME. That is as an entity, not for one specific——

Mr. CONAWAY. Is there an overall speculative limit for the entire cotton market?

Dr. NEWSOME. I cannot speak to cotton.

Mr. NICOSIA. No, there is not. Only for an individual.

Mr. CONAWAY. So all these limits that we are all talking about—that are being discussed here is on individual participants. So that if you had a lot of participants in the market, who each of them had a certain limit and they all did the limits you could still mechanically get to these higher volumes of things that are going on?

Mr. NICOSIA. Absolutely. I think the other problem that we had in the earlier testimony was the idea that this excess buying does not push prices up. I don't know how anyone can come to that conclusion, whether it was a NASDAQ of 1999 or whatever. Excess buying pushed prices up. Just as if we asked today for all of that index money to disappear, what do you think would happen to prices? They would all go down. They would have to go down until they found someone else willing to take the long side and assume the risk at a lower level. Today the index funds are crowding out other buyers. If China wants to come in and buy corn, beans,

wheat or cotton, they have to compete with an index. There is one bushel to sell. They are both going to buy it. It is a bidding war between the two of them. So it does affect prices. Maybe not improperly, but it absolutely affects it. Whether they are in the delivery market or not.

Mr. CONAWAY. Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. Thank you. The gentleman from California.

Mr. COSTA. Thank you very much, Mr. Chairman. I, like many of my colleagues, am still trying to get my arms around this complex issue that obviously is a cause of concern for many as to the impacts not just on the general commodity markets but of course on energy. Mr. White, you made a comment in your opening statement that I am trying to figure out. Obviously we are all concerned about adverse impacts of speculation and you seem to believe that it has had a significant impact. And I don't know how we would rate that. But in the charts that you use, that you provided, out of the five major oil fields in the world, four of them are all in decline, and one could maybe argue the fifth is in decline as well, not to mention others. And we know that demand for the product has risen rapidly as a result of the economic growth of China and India and other parts of the world.

So I am wondering how you discount that and what percentage you are really able to make a determination because I believe in part—well, I believe the laws of supply and demand are impacting. It is one of the reasons I think we are in an energy crisis. And I am trying to figure out how much blame, or responsibility maybe is a better word, on the issue of speculation.

Mr. WHITE. Yes. Basically what you have is you have a situation of supply and demand and demand. You have your normal supply and demand and then you have this additional financial demand. So exactly like Mr. Nicosia said, the index speculators are demanding futures just like China or any other of the physical commodity consumers would be demanding futures. And so the problem is that, take 1998 for example, on average, 80 percent of the positions on long and short were held by physical hedgers, 20 percent by speculators. So physical hedgers outnumbered speculators four to one and the market worked fine and prices reflected supply and demand. Today, on average, index speculators are about 40 percent of the long side. Traditional speculators are about 25 percent. And then physical hedgers make up the difference, about 35 percent. So index speculators are bigger in terms of long positions that they hold than any other category. And together with other speculators, they outnumber them two to one.

Mr. COSTA. I don't know, maybe because of the opaque nature of the group of investors that we are talking about, maybe it is not possible to determine. But do we know what percentage of those that are participating that you just indicated may be investors from China. Or, have you heard from some of these other places that are also—we are competing with for the product, for the energy?

Mr. WHITE. Let me understand the question. So you are saying of the 40 percent of index speculators, how many of those might be foreign index speculators?

Mr. COSTA. Right.

Mr. WHITE. I don't know the answer, but it raises a great question and that is some people have said that sovereign wealth funds could be anywhere from 10 to 20 percent of that money, and so it would be very unusual to see petro dollars. They make money when the price of oil is high and then they turn around and buy an index. But that is the only number I have ever looked at.

Mr. COSTA. Carly Gavars likes to say that if in fact the Chinese attacked Taiwan that we would have to borrow money from the Chinese to protect the Taiwanese. That is not the subject at hand of course. But to all four of you I want to ask the same question. Think about it precisely and concisely. We have had yesterday and I suspect you are familiar with them and there are other pieces of legislation out there that all attempt to provide a fix for the issue that you have just testified for.

What do you precisely believe the fix ought to be if Congressional action is taken that would address very simple—because I am a layperson, and I am not into the weeds like all of you are on this, but what are the one, two, three in priorities, simply stated?

Mr. WHITE. Okay. You are looking at me so I will—what we need is we need speculative position limits, Federal speculative position limits across all commodities, across all exchanges, including the over-the-counter swaps market. If we don't include swap, which are bigger than the futures, then we have left out a big portion of it. That is the main thing. I would also further say that I would like to see index investors told that they can't index anywhere. They can actively invest, trade, buy and sell, but no more indexation for what it does to the market.

Mr. COSTA. Okay. Mr. Nicosia. I assume that everybody believes transparency is a good thing.

Mr. NICOSIA. Without a doubt, the number one issue has got to be transparency and closing the loopholes to circumvent CFTC regulation and CFTC limits. Today it is just rampant and it is easy. So you need to close the loophole.

Two, you need to open up the transparency of that aggregative positions. So once you close the loopholes, you also need the transparency and the reporting so that people can look at the aggregate of all trading activity both on and off-exchange.

And third, some type of limitation on index money. There may be a space for an index product to be in there, but to allow an index to put as much money it wants at any point in time simply because it has more money, the same right that is denied other participants, makes absolutely no sense to me. So limiting on the index money would also be an appropriate behavior.

Ms. COCHRAN. I will go back to the issue of transparency. I think the first thing that we would like to see is that the CFTC has access and visibility into all the markets that they need to have access and visibility into. And then reporting to the public through reports such as the Commitment of Traders report, information that doesn't reveal obviously any proprietary information but allows the market to understand who has what positions and the impacts on those markets. We have seen that on the ag side and it has been very efficient.

Mr. COSTA. You are batting cleanup.

Mr. LASALA. Yes, I am Tom LaSala. I am the Chief Regulatory Officer with NYMEX. I am filling in at the moment for Jim Newsome. I think everyone before me has said transparency. NYMEX is in favor of transparency, noting that, however, it needs to be on a reasonable basis. The notion of getting ingress to the OTC books is going to be extremely, extremely difficult. Additionally, some of the action taken with regard to the foreign boards of trade insofar as again transparency, comparable regulatory handling, position limits, actions moving on that, we support that. Additionally Dr. Newsome spoke to NYMEX advocating limitations on hedge exemptions that would be pursuant to the last 3 trading days for any swap dealer who has exposure directly related to noncommercial counterparties. So we would legislatively support that also.

Mr. COSTA. Thank you very much, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. The gentleman from Virginia, the Ranking Member.

Mr. GOODLATTE. Thank you, Mr. Chairman. I am sorry. What was your name again?

Mr. LASALA. Tom LaSala.

Mr. GOODLATTE. Mr. LaSala, I wanted to ask this to Dr. Newsome, but you are the designated hitter. So let me ask it to you. We are told by one of the Members of Congress that testified yesterday that in 2000 physical hedgers accounted for 63 percent of the oil futures market and speculators accounted for 37 percent. But by April of 2008, physical hedgers only controlled 29 percent of the market and that 71 percent of the market is now swap dealers and speculators. Meanwhile your testimony, or Dr. Newsome's testimony I should say, states that your data analysis indicates that the percentage of open interest held by speculators relative to commercial participants actually decreased over the last year, even at the same time that prices were increasing. That noncommercial long and short speculators, in other words, consistently have been in the range of 30 to 35 percent of the open interest. This would mean that hedgers make up the balance of 65 to 70 percent of the market. It is much different than the 29 percent cited by yesterday's testimony.

I wonder if you can help shed some light on exactly what the available data is telling us, how do you define commercial and noncommercial, and what is included in these categories?

Mr. LASALA. What Dr. Newsome was referring to was the traditional noncommercial that the CFTC who categorizes the parties in the Commitment of Traders reports as commercial or noncommercial would be individual speculators. I believe they would put index funds in there, wealth funds would be in there. That would be noncommercial. And what Dr. Newsome spoke to was that category's report about the CFTC in the past year as a whole decreased during rising prices. However, the larger percentage that you spoke to definitely bundled in effect actively every bit of open interest that someone might categorize as being applicable to a, "swap dealer." We are quite confident that that is not the case. We are quite confident that when the CFTC, who has made calls to the swap dealers to look at the underlying books, you will absolutely confirm that that is not the case. And again, gentlemen, if you think about

it, people that are going to swap dealers, they are absolutely commercial entities, whether they be airlines, or a home heating oil dealer, laying something off on the heating oil market. We are all familiar with that market where they are looking for fixed price protection and they can't manage it themselves. The swap dealers would be the ones prospectively laying off in the futures markets their net. I stress to you their net exposure. They are always going to look to effectively balance their book internally with offsetting risk and only effectively hedge in the futures market to the extent their net exposure.

Mr. GOODLATTE. So you would contradict the percentages that were cited here yesterday?

Mr. LASALA. Absolutely.

Mr. GOODLATTE. Let me ask you. Some have called for higher speculative margins to tamp down on speculation. What has NYMEX observed with your recent margin increases? Would a systematic increase in margin reduce prices?

Mr. LASALA. Would a systematic increase in margins reduce prices? No. It is going to prospectively have an effect on not only noncommercials but commercials, potentially pricing people out of the transparent market, pricing them out of hedging. I think it could translate into a more volatile and higher priced market. NYMEX does not set its margin, you referenced a number of margin increases recently. I am quite frankly very closely involved in the setting of the margins. Our margin setting policies are not aimed at a percentage of the notion of value. It is not aimed at controlling participation of the market. It is aimed at covering risk. And we look at the volatility in the market and we are looking to cover with 99 percent surety a 1 day move. That is how we have traditionally managed margins at NYMEX. I think you would find that broadly speaking that the futures industry has done this.

Mr. GOODLATTE. Some of your fellow panelists have called for limits on positions, particularly by the index funds. What is your position on that?

Mr. LASALA. I think it was also noted, my position would be this. Our hard position limits are in effect the last 3 days. Broadly speaking, the index funds are long gone before then. I would also say to you that broadly speaking, as a matter of fact, we have in any 1 month accountability level of 10,000 contracts. During the pendency of the front month, when the 10,000 contract accountability level is in place, we certainly look at the position of index parties and everyone. And I can tell you that if someone were to go through the 10,000 and have a substantive concentration, we would act upon it. And the best demonstration of that is documented by the Senate Permanent Subcommittee relating to the Amaranth matter. I directed a reduction of positions and that wasn't subject to a position limit violation. It was subject to their piercing the accountability level.

So I think that effectively managing your use and management of accountability is an effective means of controlling speculation. You simply have to commit the time and the effort and the money and the resource to do it. And I believe we do that.

Mr. GOODLATTE. Let me ask if any of your fellow panelists, Mr. Nicosia, Ms. Cochran want to respond.

Mr. NICOSIA. Yes. If everything was a perfect world and all the information was on an exchange, then what was just said would be absolutely true. The problem is that if you have a 10,000 contract limit of whether it is 5,000 in cotton, 10,000 in crude oil, the truth is you have no idea what that guy's total position is today because all you see is the subset on your exchange.

What he has in his own swap position, if he wants to exceed that, he can do that tomorrow on two trades in the swap market. So although ideally it is great if the exchange could be able to control that, they don't have full information. Neither does CFTC. How can we worry about a 5,000 or a 10,000 contract limit when all they are looking at is one subset, and everybody knows what those limits are and they can stay under them on the exchange. When they want to exceed them, they go off-exchange.

Mr. GOODLATTE. Mr. White, do you agree with that?

Mr. WHITE. Yes, I agree with that. It goes back to the point that if you put speculative position limits on the exchanges but not on the swaps market, you haven't achieved much because the swaps market is huge relative to the exchange.

Mr. GOODLATTE. Mr. LaSala, what would you say in response?

Mr. LASALA. I am sorry I missed it.

Mr. GOODLATTE. What would you say in response?

Mr. LASALA. I missed the point he mentioned. Forgive me.

Mr. WHITE. I just said that if you put limits on the exchange, but you don't put limits on the swaps then you haven't achieved much because the swaps are so much bigger than the exchange.

Mr. LASALA. My response to that would be that generally the swap market is bigger, but, again the swap market is not the preeminent pricing market that you see. It is not the transparent market that the exchange is. And there are custom tailored deals that are occurring in the swap market. While I will say that there is an interrelationship, just like there is an interrelationship between the futures market and physical market like Dr. Pirrong said earlier, I don't think you have that same absolute relationship. You are going to make a transaction, take a position OTC which could be balanced by the swap dealer with another counterparty and that that is immediately going to translate into a push up or down, for that matter, in the futures market.

Mr. GOODLATTE. Mr. White, what do you have to say about that? The Chairman asked an earlier panel the same question. That is, if you have a private swap, how does that get reflected in the price of oil overall? How does that drive the market price upward?

Mr. WHITE. Well I am glad that came up because I was thinking about it through the first two panels. And I have an analogy for you. Okay.

Mr. GOODLATTE. My speech and debate coach in college said, analogy is the weakest form of argument. But go ahead.

Mr. WHITE. Okay. Well, with that, here is my analogy. Back in the Middle Ages, the way they used to buy and sell commodities is at the marketplace. It was in the city and they would have fairs at harvest time. And all the farmers from all around the countryside would come to the city. They would buy and they would sell and they would see what the supply was, they would see what the

demand was from millers and brewers and stuff for this commodity. And that is how the prices were set.

Now imagine if you had an enterprising grain merchant that said, "I am going to go set up a stall on the side of the road and intercept people as they head into the city and offer them prices, and maybe I will buy and maybe I will sell outside of the city." And that is what swap dealers basically do. So in other words, if you have a wheat farmer that is coming to the city to sell his wheat but he never makes it because he did a deal on the side of the road before he ever got there, then that is less supply that exists in the city. That is less supply that exists in the futures market because it was offset in the swaps market.

Mr. GOODLATTE. But isn't it also true that there is less demand in the city because you also had somebody on the outside who was willing to sell on the outside?

Mr. WHITE. That is exactly right. You have somebody that is willing to buy on the outside called an index trader that is willing to buy in the swaps market and offset that supply that would otherwise come to the exchange. And that is why prices move up on the exchange in relationship.

Mr. GOODLATTE. Why would they move up if you have also taken some of the demand out of the market too because you have a person who doesn't make it to market who was willing to pay a certain price? You have less supply but you also have less people there with the cash to buy.

Mr. WHITE. The point is, it is all demand. It is all one market effectively. From a swaps dealer's perspective, all I care about is barrels. And if I can buy barrels for future delivery on the futures on the futures exchange, I will do that. If I can do it in an over-the-counter market, I will do that. It is all one market to them. That is the way they see it. So the point is is that an index trader going to the over-the-counter market and putting their demand there will have the same effect as an index trader going to the futures exchange and having their demand there. So yes, their demand has an impact whether it was on the futures exchange or whether it was over-the-counter.

Mr. NICOSIA. Mr. Congressman, could I answer that also?

Mr. GOODLATTE. Sure.

Mr. NICOSIA. I am not going to use an analogy. I am going to use real life. Because we do do those transactions. And when they come in, we take the opposite side of that and we immediately go to the exchange and lay it off on that transaction in the exchange. So it creates immediate activity on the exchange. And if you happen to take a large retirement pension fund, if they decide to put $1 billion at work into the commodity market, it creates $1 billion of buying on the exchanges, period.

Mr. GOODLATTE. Would you like to respond to that, Mr. NYMEX?

Mr. LASALA. Yes. And I will just simply note something that was stated earlier. Following the gentleman's point, he said he immediately creates this activity on the NYMEX or on the exchange. Okay. So we are going to give merit to that activity, let's assume in an upward—hypothetically—in an upward fashion. But what happens when that position has to be liquidated? Do we just completely ignore the liquidation? This is one of the things that I am

puzzled with. How is it that everyone is willing to give merit to the presence of a buy in the market but completely disregard the exodus?

Mr. NICOSIA. The exodus will be just as great. You are absolutely right. When they go to liquidate, the push down will be just as great as the push up from where it is, from the relative level of imbalance that has taken place. I mean, this is fairly simple stuff. When you create extra money that flows through from the buy side, the only way that you can incentivize someone else to sell because you have to have a buyer and a seller is to create a higher price to bring in a seller at a higher level than he is willing to accept a risk to take the short side of that transaction. And when this money leaves, if it ever leaves, it will be just as disruptive on the way down. Because he is right. It is a matter of money flow. It is no different than it is in stocks as it is in commodities. If you have more buying come through, prices will rise until you reach a level that someone on the other side is willing to accept the risk to go short.

Mr. GOODLATTE. Let me ask all of you. One of the proposals that we have heard about is requiring enhanced reporting requirements that the CFTC should be directed to devise new classifications of trades to break out index speculators or swaps as a separate category. I can kind of guess how Mr. White and Mr. Nicosia will view that. What is your view of that?

Mr. LASALA. We would support it. We have no problem with that.

Mr. GOODLATTE. Does everybody take that position?

Ms. COCHRAN. We do, too.

Mr. NICOSIA. Absolutely.

Mr. WHITE. I would just like to point out that that will not bring prices down. That will do nothing to prices. But yes, we are in favor of that.

Mr. GOODLATTE. Well, we are trying to find out what will bring prices down. And we have one opinion from you and one opinion from you. So when we find something that people think will help with some discovery, we are encouraged by that. But then you say, that still won't help bring prices down, it makes us wonder whether anything will bring prices down because the real problem may be that the overall supply worldwide is not keeping up with worldwide demand and that is the real cause of prices moving upward.

Mr. WHITE. Well, to me, it is really simple. It is the money flowing in that pushes the prices up. An when the money flows out, the prices will come down. And the money hasn't flowed out. And what happens every month is the index traders just roll to the next month. They don't exit the position. They just roll it to the next month. So the money hasn't come out yet.

Mr. GOODLATTE. Well, let me ask you this: It has also been proposed that we ensure that only true physical hedgers qualify for hedge exemptions. Do you have a view on that?

Mr. LASALA. Sure. I would disagree with it. If you are saying that you don't consider swap exposure per *bona fide* hedge, we would absolutely, again, use your heating oil dealer. Do you not want to get a price fix on your gallon of heating oil? That pricing program that probably everyone in this room has heard about from

their home heating oil dealer, if he wants to pass a fixed price along, he is going to, in many instances, go to the swap dealer. So if you are saying that now that swap dealer cannot prospectively do that across multiple heating oil dealers in this example, you are cutting out a utility that is in the market that would be just absolutely devastating.

Mr. GOODLATTE. Even though that utility would not qualify as a physical hedger?

Mr. LASALA. The heating oil dealer in my example could qualify as a commercial. But what I was responding to was if he got an OTC swap and you discounted the ability of a swap dealer to get an exemption, I think that would be detrimental.

Mr. GOODLATTE. Anybody want to respond to that? Mr. White?

Mr. WHITE. I just wanted to respond to your question. I think if I understand your question correctly, it was that the proposal has been made that you only get a swaps exemption to the extent that you have *bona fide* physical hedgers that you have done the swap with.

Mr. GOODLATTE. Yes. Hedge exemptions should be available only to true hedgers that have a physical underlying exposure to a commodity. Speculators should not be allowed to use this exemption to avoid position limits. For example, a financial trading subsidiary for an investment bank or an index fund should not qualify for a hedge exemption. Neither entity has a natural long physical ownership or a short physical need for commodities.

Mr. WHITE. I don't think we should get rid of the swaps market. I think we should keep the swaps market. I think the swaps market is important. And I do think that what Mr. LaSala has been saying is true, that a lot of swaps involve commercial *bona fide* physical players. And if you eliminate all speculation from the swaps market, then it would be the same as if you eliminate all speculation from the futures market. It wouldn't have the necessary liquidity that it needs. So the remedy for excessive speculation is speculative position limits. It is not elimination of speculation.

Mr. GOODLATTE. You would not ban index funds from speculating?

Mr. WHITE. Well, that is different. I would prohibit index funds because they are passive, long only, broadly diversified. Index is separate. Okay. So, in other words, keep the speculators just put limits on them; keep all the *bona fide* physical hedgers; keep the swaps market and the futures market and everything else.

Mr. GOODLATTE. Would you have the Congress set those limits? Or would you allow the CFTC the discretion to set the limits?

Mr. WHITE. My personal recommendation is that we have the *bona fide* physical hedgers in each one of those commodities set the limits. We have the Mr. Nicosias of the world. We have a panel on both sides, producers and consumers, you know six each or whatever that make a recommendation to the CFTC. And then if the CFTC wants to override it, then they can say why they want to override it. But I think the actual physical hedgers are who the market exists for. I mean, that is what these markets are for is for the physical players, not the speculators.

Mr. GOODLATTE. Let me ask one more. It has also been proposed that we close the foreign exchange loophole. I guess that is the so-called London-Dubai loophole. It has been proposed that all foreign exchanges offering commodities through a U.S.-based terminal should be subject to the same regulatory requirements applicable to U.S. exchanges including position limits, margin requirements and reporting. Further, U.S. traders trading on non-U.S. markets should also be held to the same regulatory requirements as those trading on U.S. exchanges. Do you agree with that as a proposal; is it a good idea? And what will be the consequence to the U.S. markets if we do that? Will the business simply go overseas beyond the reach of our regulatory controls? Mr. White, let me ask you. And we will go right down the panel and everybody will answer that.

Mr. WHITE. If I understood it correctly, then basically I just believe every exchange ought to play by the same rules.

Mr. GOODLATTE. Correct. But the question is, can we make other exchanges play by the same rules?

Mr. WHITE. Sure. Absolutely.

Mr. GOODLATTE. How?

Mr. WHITE. If we want to. Anybody that is based in the U.S. is subject to U.S. limits. Anybody that is residing in the U.S. with a terminal in the U.S. is subject to U.S. limits.

Mr. GOODLATTE. If they are speculators, in other words, if they are an oil business, obviously that would easily apply to them. But if they are simply speculators in the market, isn't it very easy for them to transfer their assets to some other location elsewhere in the world so that they can then participate on an exchange that is not subject to those regulations?

Mr. WHITE. Yes. Basically physical hedgers today have no limits; they never had them and they never will.

Mr. GOODLATTE. They are out of the picture. We are talking about speculators?

Mr. WHITE. Right. So any speculator——

Mr. GOODLATTE. Not going to take delivery.

Mr. WHITE. That is below the limits has no incentive to go elsewhere either. You would much rather be in the U.S. with U.S. banking, U.S. financial system, U.S. regulation.

Mr. GOODLATTE. Would you? Why?

Mr. WHITE. Why? Because you have the physical hedgers here, and they are the ones setting the prices that truly reflects supply and demand. It is not a speculative casino in the sky. It is a real market.

Mr. GOODLATTE. Aren't there hedgers out there in the world that are hedging——

Mr. WHITE. Plus you want the liquidity.

Mr. GOODLATTE.—based upon delivery in Europe or delivery on the Pacific rim or delivery in China?

Mr. WHITE. Yes. And my recommendations have nothing to do with that. I mean Brent crude is going to trade in London and it is trading now. It is Brent crude. It has nothing to do with the U.S. I mean, Oman, sour crude, trade 'em up.

Mr. GOODLATTE. What about oil that is coming into the United States that is not produced in the United States?

Mr. WHITE. Exactly. It is delivered in the U.S. It is U.S. It can be regulated and the U.S. regulates anything coming into its borders.

Mr. GOODLATTE. Mr. Nicosia.

Mr. NICOSIA. In regards to the first part of your question as far as the overseas exchanges, I think that is mostly an energy reference. And I don't have much of an opinion on that. As far as the question you asked about the outflow of cash and/or trading to other exchanges or to other places, I think that it is a very weak threat and one that I would put very little credence in. Money flows to opportunity and it is going to flow to liquidity.

And the best liquid exchanges in the world are here in the United States. It also has the best laws to protect those tradings. It also has the best regulatory situation and people's money is safe here. Continuously, other exchanges have tried to open with numerous different contracts and different locations and the majority of them all fail. So the money is going to go where it is safe and where it is liquid. So to the extent that if we are worried about our exchanges being in trouble I am not worried about that in the least.

Mr. GOODLATTE. Ms. Cochran.

Ms. COCHRAN. I would have to slightly disagree with Mr. Nicosia. Our membership represents a broad spectrum of commercial participants and noncommercial participants as well. We have some individual speculators that are our members and I have heard resoundingly from all of our members that they have a lot of concern that while they want additional transparency and reporting requirements on all of those things, if regulations and laws aren't enacted, that makes doing business on U.S. futures exchanges more expensive, that the money will go somewhere else. Either it will go off-exchange or it will move to other markets somewhere else in the world and outside of the jurisdiction of the United States. And in a world of electronic trading, that becomes easier and easier.

Mr. GOODLATTE. Mr. LaSala.

Mr. LASALA. I will follow up and agree with the point Ms. Cochran just made. In that if we over-legislate and make doing business in the United States, you know, 50 percent margins, ridiculously low position limits, just simply make it so uncomfortable for people to conduct commercial activities, I fully contemplate, and as you know, there are other energy exchanges, other clearinghouses around the world. There are other markers that people can use other than the reliable one that we have had. We can lose that business.

We have been in favor, as stated earlier with regard to the changes that have been proposed and put into effect on conditioning the No Action letters, having comparable position limits, having large trader reporting. We can't control the margin policies of overseas DCOs. But in terms of keeping a level playing field for a U.S. commodity, WTI where there is a look-alike done overseas, we completely support that. If I could just add one point, if I have heard Mr. White before, unless I misunderstood him, he made a comment that there are no limits for commercials in NYMEX or in the U.S. That is not correct. The expiration limits, the accountability levels, any 1 month and all months are applicable to every-

one. We exempt in the last 3 days if it is demonstrated what we think appropriate *bona fide* exposure to parties to prospectively higher levels. But I want to be clear.

And as Dr. Newsome stated earlier, this is not just a blanket exemption. You are exempt. Go do what you will. They ask for finite numbers. We evaluate carefully not only what the reasonableness of their need is, how appropriate is it, does it make sense. But also, wouldn't dare give someone just by size alone the ability to bully the market. I will state to you that, broadly speaking, if you took the largest exemption assuming that someone went up to the greatest extent of that in our markets on the last day, it would be less than 25 percent of the open interest. And obviously that percentage is smaller as you go to the second to last day, third to last day because the open interest is tunneling down.

So we are extremely conservative and mindful of not giving wide open limits. Thank you.

Mr. GOODLATTE. Thank you, Mr. Chairman.

Mr. ETHERIDGE [presiding.] Thank you. I thank the gentleman. And I yield to the gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman. I assume our clock is off at this point. Were you here and did you hear Dr. Irwin and Dr. Pirrong's testimony, Mr. White, Mr. Nicosia in particular?

Mr. WHITE. Yes. Yes.

Mr. NICOSIA. Yes.

Mr. MARSHALL. How did they get it so wrong? They have been at this for what, 30 years, both of them? Could you enlighten me?

Mr. WHITE. I don't know about enlightening you. But what they are espousing is the academic and what is taught in the finance textbooks. I was at University of Chicago when Dr. Pirrong was a professor there. We met and talked about that. I think it is a fundamental misconception between financial futures and commodities futures. So what they teach you in business school is that the spot price is an anchor, that futures prices have to convert to spot, that the only thing that can affect spot prices is supply and demand fundamentals, and that the only way that the futures price can affect the spot price is if it somehow affects supply an demand.

But that is just wrong, because there are four ways in which the futures price can affect the spot price. Beginning in the 1980s in the energy markets, many energy participants decided that they were going to price their spot deals off the futures price. So I call up and I say, "I would like to buy a tanker full of crude. What am I going to pay?" And they say, "You are going to pay the NYMEX futures price plus or minus a differential." That doesn't have anything to do with the last 3 days. That is just the nearest expiration futures contract.

So when that futures contract goes up, the real world spot price goes up. That is one. Second of all, there are a lot of contracts that specify the futures price. Now you might ask yourself, why do they want to use the futures price? The answer is because we can hedge the futures price if we specify the basis in the contract, then we can use the futures to hedge it and we have eliminated our risk, plus they all agreed back in the 1980s that the futures price was the best price. It was the best indication of what was going on.

And it was. Because it was largely determined by supply and demand because it was just modified physical hedgers in that market. Then there is arbitrage. That is the third thing. You can arbitrage the price. Okay. You know which is basically going to cause convergence. So if you have a giant elephant buying in the futures price and you are trying to converge, and then the fourth thing is that it is the benchmark for everything they do. There is not a guy in the swaps market that is not aware of where futures prices are and cash prices. There is nobody in the cash market that is not aware of where futures prices are. And it is very easy, well, I shouldn't say it is easy, but there is a strong relationship between futures and spot that is not part of the academic literature.

Mr. NICOSIA. Also I wouldn't say that they necessarily had it all wrong but I do think that they miss reality. And for example when Professor Pirrong was talking today about how the speculator is gone by the time delivery comes, therefore, they are not affecting delivery price that takes place with real supply demand when we go into delivery and that is ultimately what it is. Since they are not in it, that does not affect the prices, that is absolutely wrong. Because that is not how commodity markets work. We are the largest handler of taking delivery, making delivery in the world. And their absence to being in the delivery market has nothing to do with setting that price because prices work in relationship to other values.

So, for example, if the nearby futures contract is going to delivery and the second month, the next month out in frontward is at a substantial premium, people will take that at any price because as a relation of the cost of carrying the commodity. They will own it and the cost of carrying it, paying interest in storage.

Mr. MARSHALL. Arbitrage.

Mr. NICOSIA. Has nothing to do with the absolute level. It has to do with the relative level. So if someone is offering you the promise of a higher price in the future, you will pay more for it today even though there is no other demand because you are buying it against his relative promise in the future. So as these indexes or other speculative positions continue to roll forward and to move their demand and buy the next month out, that creates spot demand for anyone who has any money whatsoever to buy the commodity and hold it against the hope; against giving it to them into the next month. By the time you get there, they move forward to the next month again. And all it does is it creates a chain where you continually link it month to month and that is where your spot demand comes. Not from the demand in the cash market of an end consumer and end-user coming to meet.

Mr. MARSHALL. You heard me ask the three members of the last panel, the two doctors. And I can't remember the guy's name who was in opposition, who took basically the view the two of you are taking of this matter to get together with the two doctors to see if they could come to what is the nub of the disagreement? Are we going to have to agree to disagree?

Mr. NICOSIA. I don't think so because I think that there is some "generalness" of agreement, to the idea that you need convergence at some point in time, that is a reasonable agreement that all of

us would agree to. The difference is that you can have convergence on an absolute or a relative level.

Mr. MARSHALL. My sort of understanding of this doesn't come close to yours. And my sort of basic understanding of this is that the two doctors were saying this index money didn't have any effect at all on price. And you differ with that.

Mr. NICOSIA. I don't see how anyone can come up with that conclusion whatsoever.

Mr. MARSHALL. Are you willing to talk to somebody who did? Could you talk to the two doctors and see if you, along with the other fellow, the three of you could get to the nub of what the two of you or the two sets of views fundamentally differ with?

Mr. NICOSIA. Right. And I do think that is a difference between today the ag markets and the energy markets that Dr. Newsome mentioned before. There is a slight difference to it. But even in the energy markets, I think there is a key difference between saying that they are responsible for prices being high as to be a difference for them to be this high. Because there is no doubt that there is an imbalance in the energy market. There is no doubt energy prices are going up with or without the speculation that took place. Whether today's price would be $125 instead of $145, I think that is fairly easy to say that the additional piling on of this demand is taking the place of demand. If you take the 900 million bushels that is held in speculative position in soybeans today and that wasn't there, someone else would have to assume that risk. Prices would be lower before someone else would accept that risk. It is the same in the energy market.

Mr. MARSHALL. For certain agricultural commodities, the law requires that the CFTC itself set position limits which you say don't work for reasons you have already described. But in any event, the law does say that corn for example being one, cotton being another that the CFTC will set position limits. The position limits are not just the last 3 days. The position limits apply to given months for yearly positions, for yearly averages, things like that. I don't know the details.

Mr. LaSala, since Dr. Newsome said there is this very cooperative relationship between the CFTC and the exchanges with regard to this position limits matter, what would be the problem with the CFTC legally being required to set position limits monthly, yearly? It is the exact same way that the position limits are set for the ag commodities in energy markets. And then y'all work well together with the CFTC anyway so you would obviously be working with them to try to find what are the appropriate limits to be set. But they wouldn't just be in the last 3 days and it wouldn't be accountability levels. There would be position limits.

Mr. LASALA. Again, I think we have a protocol that has worked. And we have worked cooperatively with the CFTC. I fear that you start mandating Federal limits and the point that I raised earlier and where we would be so far out on a limb insofar as disparate with other regimes FSA, DFSA, you can look around the world, does not even require large trader reporting. We are not saying that is right. We think there should be position limits, position accountability, but I have a sincere concern that we could prospectively drive business away if we just simply over-regulate this mar-

ket. You know to be clear, gentlemen, it is a process to negotiate exemptions to position limits. I regularly go through—over the course of the hundreds of commodities, we have put hard limits on everyone. We have competitor exchanges that have no limits. When I go and try and administer even the front month one there are comments that are made that this is a hassle. I am going to this less transparent market. And I think that that is absolutely what could happen. I think it would be detrimental to transparency and the good of functionality of these markets as they operate today.

Mr. MARSHALL. Mr. Nicosia.

Mr. NICOSIA. Well, again, when we asked the earlier question, I do agree to the extent that if we were to raise fees and/or margins to unreasonable levels, that will drive stuff to overseas marketplaces. But again, I think that as far as you are looking for legislation or rules or ways to try to solve other loopholes, it is hard to solve excess speculation *per se.* But you have to realize how the real market works. You don't even have to get a hedge exemption. Every fund, any money that wants to, just call someone with a hedge exemption and put the order in with them.

Mr. MARSHALL. Right.

Mr. NICOSIA. They use other people's hedge exemptions to get around this. So our biggest concern is that in order to get a handle on it first——

Mr. MARSHALL. It has got to be market-wide.

Mr. NICOSIA. You have to be able to take all the pieces and put them together. Because otherwise it is like trying to plug one hole in a net. It just goes out another side of the net. You can't do it. And until we know the extent of the problem if there is a problem, we can't fix it because we may be fixing the wrong thing. So I don't think you can necessarily legislate against speculation. I think it is very difficult to try and I would not raise limits. I wouldn't raise limits but I also would not raise margins or user fees to that extent because I do think that it would drive business overseas. But we have to try to get our hand upon all of these circumventing trades to take place to go around transparency. That is where you must start before you throw the baby out with the bath water.

Mr. MARSHALL. We discussed it in an earlier panel and you might have been there as well, the possibility of having the over-the-counter market, the swaps market provide reports to the CFTC to enable the CFTC to see what is going on. But those reports would not be public information. So presumably one of the objections that the swaps market might have, and that is somebody would get ahead of the hedging opportunity.

Mr. NICOSIA. I think that was a huge fallacy that you heard earlier today. I find it very interesting that I have to report those. So why is it okay that I report my activity? I have to report my cash activity, my swap activity. I report all of that activity today. For them to see against me. But they don't have to report it?

Mr. MARSHALL. Do they see it?

Mr. NICOSIA. Absolutely they see it. They see it in aggregate.

Mr. MARSHALL. They see it in aggregate but they don't see the individual position.

Mr. NICOSIA. No, and I don't think anybody has ever asked to see it individually. I think they want to see it in aggregate, both aggre-

gates from a general component and then to aggregate individuals' positions from CFTC's standpoint alone to see if they are circumventing position limits. But today you don't get anything. Not only do you not get a reporting of a swap, you don't get any of the counterparty information either. So that if an individual had five swaps, with five counterparties and that in total aggregates to something, there is no way or no venue today to try to bring that into one location. That should be CFTC's responsibility.

Mr. MARSHALL. I know you have been doing this orally and very much appreciate your testimony both you and Mr. White, all of you. But with regard to this dispute between the doctors and you with regard to the impact of this passively long index fund money, would you be willing to submit something by Monday in writing that specifically addresses that and points out why the two academicians just have it wrong?

Mr. NICOSIA. Unfortunately I wouldn't won't be able to because I leave here to join my family for 3 days of vacation but some time soon thereafter, I would be happy to.

Mr. MARSHALL. Could you get Neil to do it?

Mr. NICOSIA. You get what you ask for.

Mr. MARSHALL. Mr. White, can you——

Mr. WHITE. Yes.

Mr. MARSHALL. It is your opportunity to take off after your old professor there.

Mr. WHITE. Right. I can do that. That is not a problem. I will just say since we have the time, there is two nubs really. One is the relationship between futures and spot. And then the other thing was they talk about where are the inventories if prices are so much higher than supply and demand would dictate, why isn't there the inventory? And the answer is is because you know the problem especially in oil and food is you can't get any more inelastic than that. It is like basically two vertical lines in the sense that you know other than air and oxygen and drinking water, there is nothing more inelastic than food. I mean that is going to be the last thing that people give up. So it is really the case where we have to pay at it, whatever the price is.

Mr. MARSHALL. I have nothing further. Thank you, Mr. Chairman.

Mr. ETHERIDGE. I thank the gentleman. Let me thank each of you. Today has been a very good hearing. The truth is, we have raised a lot of questions. We have a lot of material to work with. This Committee will recess until tomorrow morning at 9 a.m. We will be back for another panel. And I think it is the intent of the Chairman and certainly is my intent as Chairman of the Subcommittee working with the Members of our Subcommittee and this full Committee to get all the data we possibly can. And these 3 days, 2 days thus far have been very helpful.

Today has been very helpful. And I think tomorrow will be, as well. And try to come back with some kind of solutions to the extent we can maybe next week after we have gathered all this data to move forward. We want to be cautious but we want to respond to the needs to make sure the market works for the producers, for the consumers and for the investors. That it works in a fair manner and that there is enough sunshine because I happen to believe

very strongly that sunshine is a very purifying source. So with that, we stand adjourned until tomorrow morning at 9 a.m.

[Whereupon, at 5:42 p.m., the Committee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUPPLEMENTAL MATERIAL SUBMITTED BY CHARLES A. VICE, VICE PRESIDENT AND COO, INTERCONTINENTALEXCHANGE, INC., ATLANTA, GA

FACT SHEET

**About IntercontinentalExchange, Inc. or "ICE"**

IntercontinentalExchange is a leading global exchange operator, comprising both regulated futures and over-the-counter (OTC) markets across a variety of product classes, including agricultural and energy commodities, foreign exchange and equity indexes. ICE owns and operates three regulated futures exchanges: (1) ICE Futures Europe, a London-based futures exchange overseen by the U.K. Financial Services Authority; (2) ICE Futures U.S., an agricultural commodity and financial futures exchange regulated by the Commodity Futures Trading Commission (CFTC); (3) ICE Futures Canada, Canada's leading agriculture exchange, regulated by the Manitoba Securities Commission.

**How Energy Futures Markets Operate**

Energy derivatives are financial contracts whose value is linked to changes in the price of an underlying energy product, such as crude oil or natural gas. Both hedgers and speculators trade energy derivatives by forecasting price trends for these commodities and taking positions in the market that reflect their price expectations for the future. Participants enter into these contracts by taking short or long positions to hedge their risk against rising commodity prices or to generate profit. Typically this does not involve the purchase of the physical commodity, so the supply of the commodity available to consumers is not reduced by futures transactions. Rather, market participants buy a futures contract on a commodity; when the contract is settled, cash payments are made *in lieu of* taking physical delivery of the commodity.

In the case of oil, investors in futures markets help to stabilize the market by providing oil producers with reliable market liquidity, enabling producers and consumers of energy to lay off risk to those willing to assume it. By conducting business through transparent and regulated exchanges like ICE, investors are a necessary part of establishing efficient, market-driven pricing in the oil markets.

**Why Additional Regulation Is Not the Answer**

Some in Congress are reacting to higher oil prices—driven by the rising imbalance between supply and demand—by proposing excessive regulations on already regulated global commodities markets. These actions are driven by the misconception that oil prices are being manipulated by excessive speculation. The U.S. CFTC (which regulates commodities futures markets) has stated there is no evidence that excessive speculation or manipulation is occurring in the oil markets.

Paul Krugman, a respected columnist for *The New York Times*, recently wrote about the myth that speculators are driving high prices in the oil market. After expressing doubts over the idea that the futures market is contributing to rising oil prices, he wrote:

> *"In any case, one thing is clear: the hyperventilation over oil-market speculation is distracting us from the real issues".*

Mr. Krugman suggested the proper role of the government is to assist the private sector's effort to develop a rational energy policy that includes real solutions such as alternative-energy technologies, new methods of conservation, and an expanded public transit.

The sustained rise in crude oil prices is not caused by the existence of the futures market, but instead by the increasing global imbalance between supply and demand, geopolitical issues, along with the depreciation of the U.S. dollar. Placing excessive regulations on this market would have adverse consequences for the U.S., its energy markets and its core commercial users without providing meaningful oversight enhancement or reducing the fundamental pricing pressures driving world energy prices.

If Congress excessively regulates U.S. exchanges operating globally, then traders will likely flock to new, less transparent markets, which are not as regulated and which are outside of the reach of U.S. regulators. For example, the Dubai Gold and Commodities Exchange now offers a crude oil futures contract that has no regulatory obligations to the U.S. regulators. Futures markets in China and India are searching for ways to develop their own crude oil markets as well—with no obligation to conduct business under U.S. law.

Driving dollars or investment out of the cash-settled futures markets by making financial participation costly or illegal is likely to result in the flow of investment

dollars into the physically-delivered or spot markets. This would amount to financial investors controlling physical inventories of crude oil, rather than a position in a "paper" or cash-settled futures contract, which puts no pressure on supply. In such a scenario, hoarding ensues, prices skyrocket, lines begin to form at gas stations and fuel rationing in the U.S. would be conceivable.

**The "Enron Loophole" No Longer Exists**

The "Enron loophole" referred to the exemptions from CFTC regulation that existed in the OTC market. While ICE's OTC business operates as an Exempt Commercial Market, ICE was never granted these Enron-specific exemptions. *Most importantly, ICE's OTC market has a 0% share of trading in U.S. crude oil, heating oil, jet fuel, and gasoline, and therefore is not contributing to any price formation in these markets.*

To increase the transparency of energy markets, Congress passed into law—in a bipartisan fashion—a provision in the 2008 Farm Bill that unequivocally closes the "Enron loophole" by extending CFTC regulation to all energy contracts deemed to be a price-discovery contract, rather than just traditional energy futures contracts. *This new legislation has resulted in extending CFTC regulation to all electronically traded OTC energy contracts, such as those traded on ICE, requiring futures-style reporting and regulation.*

The Chairman of the CFTC has stated for the record that the "Enron loophole" has been fully closed and that the CFTC has sufficient authority to police the OTC energy markets:

> **Senator Carl Levin (D–MI):** *"Could I ask a quick question of Mr. Lukken? Have we effectively closed the Enron loophole, in your judgment?"*
>
> **Walter Lukken (Chairman, CFTC):** *"Absolutely."*
>
> *[Senate Committee on Homeland Security and Governmental Affairs, CQ Transcripts, 6/24/08]*

Many leaders in Congress concur that the years of work put into eliminating this unnecessary loophole have resulted in significant reform for the previously unregulated OTC markets. Now Congress must give the Act time to work.

**The Existence of a "London Loophole" Is a Myth**

The mythical "London Loophole" is propagated by those who inaccurately believe that the WTI oil futures contract offered by ICE Futures Europe (IFE) is subject to substantially less oversight than its U.S. counterpart NYMEX. Since 1981, IFE has been located in London and fully regulated by the U.K. Financial Services Authority.

While the Commodity Exchange Act prohibits the CFTC from directly regulating foreign exchanges, it permits foreign access to U.S. customers through the "no-action" process—today nearly two dozen foreign exchanges operate in the U.S. pursuant to this process. IFE originally received its No Action letter from the CFTC to provide screen access to U.S. traders in 1999. Recently, IFE has agreed to amend its No Action letter with the CFTC, now ensuring that the WTI oil futures contract *will be subject to equivalent U.S. position limits and accountability limits.*

**Proposed Legislative Solutions**

ICE stands ready to work with Congress to help ensure that the commodity futures marketplace is functioning in an appropriately regulated environment that protects market participants and prevents market manipulation. We believe there is a clear need to provide more funding and staffing to the CFTC to carry out expanded responsibilities in a rapidly growing marketplace. Funding has been cut and staffing is at all-time lows in a marketplace where commodity trading has been transformed by global growth and competition. The CFTC warrants increased resources so it can continue to ensure the integrity of all markets within its jurisdiction. Furthermore, we believe the exchanges should provide enhanced quantity and quality of information to the CFTC, an initiative that ICE is actively participating in today.

NEWS CLIPS

**The Usual Suspects: Are Financial Investors Driving Up the Cost of Commodities?**

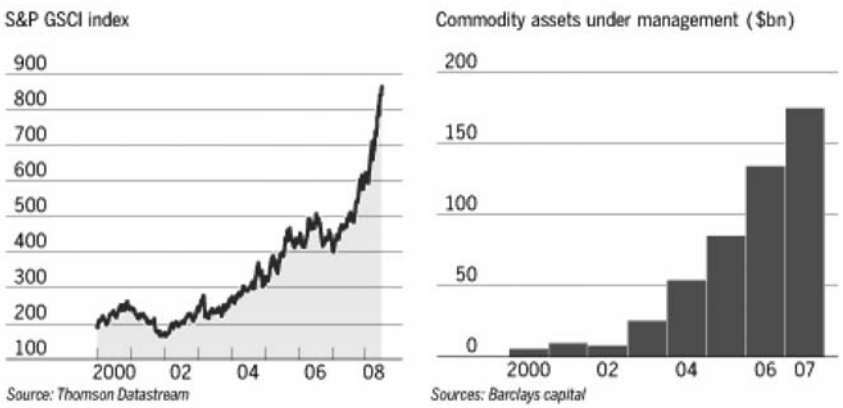
*Silicon Investor*
By Javier Blas and Joanna Chung
7 July 2008

Prices were outrageously volatile. While traders attributed the sharp market movements to supply and demand, most politicians in Washington were sure that speculation was the culprit. The U.S. public became incensed.

The year was 1958, the commodity in question onions. Congress held long and sometimes tumultuous hearings in which Everette Harris, then president of the Chicago Mercantile Exchange, tried to convince lawmakers that the futures market for onions was not the cause of the volatility. "We merely furnish the hall for trad ing . . . we are like a thermometer, which registers temperatures," Mr. Harris told a hearing. "You would not want to pass a law against thermometers just because we had a short spell of zero weather." But such arguments were ignored and in August of that year the Onion Futures Act was passed, banning futures trading in the commodity.

Fast-forward 50 years and it seems that little has changed. The recent surge in commodity prices has sparked an intense and politically charged debate on whether financial investments—to some, plain speculation—are affecting the markets. Pension funds and other big institutions today hold about $250bn in commodities, mostly invested through indices such as the S&P GSCI, a widely accepted industry benchmark. This compares with just $10bn in 2000, although part of the increase represents the rise in prices rather than fresh flows of money.

**Commodity prices have risen as institutional investment has flowed in ...**




Surging prices for energy and food have caused a political storm in Washington, where U.S. politicians from both parties have been scrambling to come up with solutions to appease voters and both presidential candidates have pledged action on the issue. In recent months, at least ten legislative proposals have been fielded and a similar number of congressional hearings have been held into some aspect of the oil markets and speculation. George Soros, the billionaire investor, spoke of "a bubble in the making" in oil and other commodities in testimony to Congress, adding

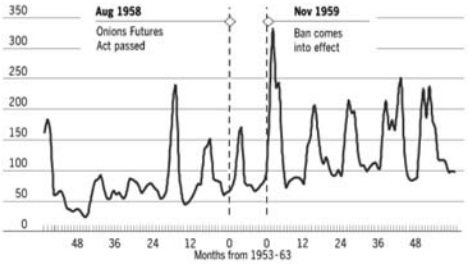
that the ability of investment institutions to invest in the futures market through index funds was exaggerating price rises.

Many politicians blame "excessive speculation" and various regulatory "loopholes" for the market situation. Joe Lieberman, an independent Democratic senator from Connecticut, is among lawmakers who say that speculative demand—particularly through commodity index funds—is one of the main forces behind surging energy and food costs. "My own conclusion is that index speculators are responsible for a big part of the commodity price increases," says Mr. Lieberman, who chairs the Senate Committee on Homeland Security and Governmental Affairs, among the Committees to hold hearings.

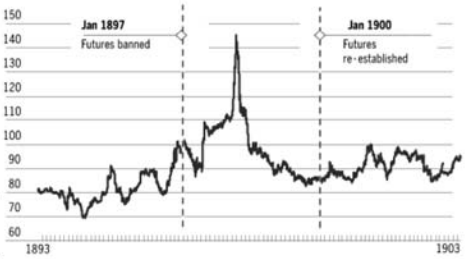
Some regulators are uncertain about the impact of speculation and *have called for further investigation.* "I don't know absolutely if speculative money is causing price rises or not but what I do know is that there are hundreds of billions of dollars that did not exist in these markets a few years ago," says Bart Chilton, a Commissioner at the Commodity Futures Trading Commission, the U.S. commodities and futures watchdog.

**...and previous attempts to reduce volatility by banning futures trading have not proved successful**

US onion futures prices, Chicago Onions (Cents per 50lb bag)




Berlin Wheat futures prices (Index)



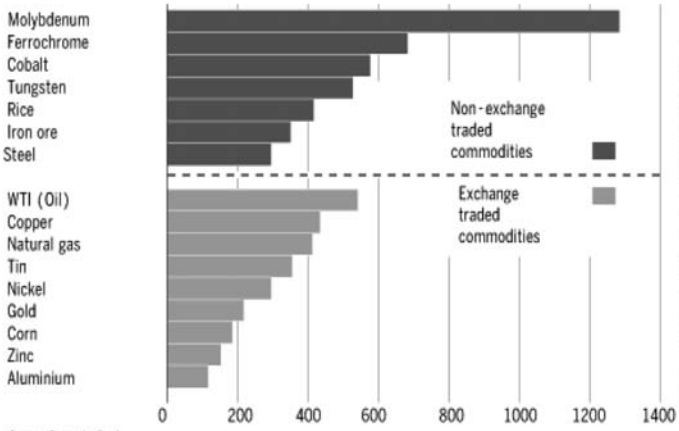

Sources: *Populist versus theorist: Futures markets and the volatility of prices*; David S. Jacks

This week, the House Committee on Agriculture is to hold 3 consecutive days of hearings to examine the various legislative proposals, some of which address whether the CFTC has sufficient resources to oversee the burgeoning futures market. The agency's staffing levels are at near-record lows, having fallen about 12 percent since it first opened 33 years ago, even as the volume on futures exchanges alone has grown 8,000 percent, according to Walter Lukken (pictured below), acting Chairman of the CFTC.

**...prompting some to attribute rising costs to speculation. Yet raw materials not traded on futures markets have also increased in price...**

The performance of financially and non-financially traded commodities

% change since end 2001




Source: Deutsche Bank

He told Congress that the agency needed "immediate additional resources" to do its job and could not carry out additional tasks at its current resources and personnel level.

Political pressure is also mounting outside the U.S. Italy is calling on the Group of Eight leading economies to tackle commodities speculators, while last week a UK

Parliamentary Committee said it would hold its first hearing into regulation of oil markets amid concern over the possible role of speculators in driving record crude oil prices.

But lawmakers could end up disappointed if they enact restrictions or outright bans on the trading of commodity futures. Indeed, a number of governments, regulators, central banks, investors and multilateral organisations have argued that such moves would be unlikely to either damp volatility or stem the increase in prices.

The U.S. regulator says there is little evidence to link price rises to institutional investors. It has maintained its stance that fundamental supply-and-demand factors combined with a depreciating U.S. dollar—which is used to price and trade commodities—are mainly behind the recent market movements.

There is, moreover, a significant difference between speculation and manipulation or illegal activity. In response to a question at one of the hearings last month, Mr. Lukken of the CFTC, said: "Speculators . . . provide a healthy mix of participants in the market to ensure there is a buyer for every seller and a seller for every buyer. That has been the case for the 150 years that these markets have been around."

He added: "We are taking steps to ensure that markets are not being overrun by speculative interests. But, to date, we have not seen evidence of that . . . [Speculators] are not all on the long side of the market, betting it will go up. So it is difficult to say there is a smoking gun there but we continue to look."

The agency, for instance, is collecting more detailed information on index funds and other transactions being conducted through so-called "swap dealers" and plans to provide recommendations to lawmakers in September.

Some go further. The International Energy Agency, the western countries' oil watchdog, recently accused politicians of looking for "an easy solution" that avoids taking the necessary steps to improve supply and curtail demand. Michael Lewis, head of commodities research at Deutsche Bank, says: "When regulators turn the lights on these 'dark markets', they will find no monsters in the room—rather underlying fundamentals driving prices higher."

The Onion Futures Act is a perfect case study. When economists studied the market, they discovered that volatility and prices were higher in the period after the ban than they were before. Frédéric Lasserre, head of commodities research at Société Générale in Paris—who has studied the onion example—says today's context is very similar. "The politicians are leading the debate pressured by the people," Mr. Lasserre says.

The onions market is not the only example. India last year banned financial trading in most agricultural commodities but prices continued to rise. "[Banning financial trading] is irrelevant," says a senior Indian official. "When a commodity is scarce, its price rises, whether it is traded on an exchange or not."

That is exactly the argument of those who say that high prices merely reflect robust demand growth—boosted by the industrialisation of populous emerging economies such as China, India and Brazil or new policies such as biofuels—against sluggish supply increases following years of under-investment.

Moreover, record commodity prices are being seen across the board, not just in raw materials with developed futures markets but also in those without significant speculative investments such as iron ore and rice, up 96.5 percent and 120 percent respectively this year. Research by Lehman Brothers shows that prices for metals that are not traded in exchanges, such as chromium, molybdenum or steel, have risen faster than prices for metals traded in exchanges, such as copper or aluminium. In addition, some of the commodities markets in which pension funds hold the largest share of outstanding contracts, such as hogs, have seen price drops.

Equally important is that price rises across the commodity spectrum are not in line. This shows that different markets are responding to their own supply-and-demand fundamentals rather than to financial investors' money flows, analysts say. The base metals market is a good example: while aluminium and copper prices have risen by about 30 percent since January, nickel, zinc and lead have fallen between

20 and 40 percent. Tin, the only metal in which pension funds had little exposure, has jumped almost 40 percent.

In another sign that supply and demand is the main driver, inventories for most commodities—including crude oil—have fallen since January. Many analysts echo Mr. Lukken in pointing out that financial investors in commodities are no longer betting only that prices would rise, as at the beginning of the boom in 2000–2001. Today, many funds are betting on lower prices.

The UK Treasury, in a report published last month, suggests that investors are not driving price increases. "Although there is insufficient evidence to conclusively rule out any impact, it is likely to be only small and transitory relative to fundamental trends in demand and supply for the physical commodities," it says.

Wall Street banks acknowledge that investor flows could influence day-to-day movements, pushing prices to overshoot or undershoot their fundamental level for a few days. But they state that investors are unable to shape the long-term trend.

Such arguments, however, seem to have proved less persuasive for U.S. lawmakers than those of other experts testifying before Congress. Michael Masters, a manager of a long-short equities hedge fund with a large stake in oil-hit airlines shares, told legislators that gasoline prices could fall as low as $2 a gallon—half today's price—with legislation barring commodity index funds. Fadel Gheit, an equity analyst at Oppenheimer, claimed that current record oil prices in excess of $135 per barrel were inflated. "I believe, based on supply and demand fundamentals, crude oil prices should not be above $60 per barrel," he said.

In response, lawmakers are preparing new legislation aimed at quickly fixing the problem of record high oil and food prices—or, as one Committee staffer put it, to "help American families right now". The proposals—several backed by political heavyweights—range from a ban on some kinds of speculation in commodities and energy futures markets, to higher margin requirements, to effectively extending the jurisdiction of the CFTC overseas. For instance, the "Close the London Loophole Act" aims to stop traders from manipulating prices and speculating excessively by routing oil trades through foreign exchanges. The "End Oil Speculation Act" proposes to increase the money, or margin, that speculators would have to put up to trade oil futures to 25 percent of the value of the underlying commodity compared with seven percent now.

Some sceptics dismiss the various proposals as political posturing. But amid the growing political pressure, the CFTC has already taken the step of imposing position limits on the crude oil contract traded on London's ICE Futures Europe exchange and a similar contract to be traded on the Dubai Mercantile Exchange, bringing limits for crude oil traders overseas in to line with limits on domestic markets. Congress recently approved legislation closing the so-called "Enron loophole" and giving greater authority to the CFTC to oversee over-the-counter derivatives markets.

Some observers of Capitol Hill suggest that lawmakers could try to consolidate the different proposals. But is unclear what laws, if any, will emanate from Congress, not least given that the White House—which has the power to veto legislation—has taken the view that supply and demand are behind the price surges. President George W. Bush recently threw his support behind proposals—forwarded by John McCain, Republican Presidential candidate—to lift the ban on fresh oil drilling off the U.S. coast to help reduce dependence on foreign energy sources.

A White House veto could be overridden if enough Republicans join the Democratic majority as they did last month, when the House voted by a huge margin—402 to 19—to require the CFTC to "utilise all its authority, including emergency powers, to take steps to curb excessive speculation in the energy futures markets". However, it is unclear whether the Senate will take up the same bill.

Political pressure is so high that some think that Congressional action is possible before the summer recess in August. One Congressional insider says: "The truth is that it is going to be very difficult to get anything done before the Presidential election . . . But this is so much a primary issue facing everyone, there is momentum." One of the bills that could have some traction is the so-called "Increasing Transparency and Accountability in Oil Markets Act", introduced by Democratic senators Dick Durbin, the Senate majority whip, and cosponsored by 15 other Senators. The bill would authorise new resources for the CFTC, including 100 extra employees, and close the "London Loophole".

Some of the more extreme proposals have already been shelved, such as one idea from Mr. Lieberman's Committee that suggested limiting certain institutional investors from investing in the commodities futures market. "After hearing from experts, the public, and holding numerous hearings on excessive speculation, our third draft proposal to limit certain institutional investors from commodity markets does not

appear to be viable at this time. It doesn't look like it would have the support in the Senate," says one Lieberman Committee staffer.

But industry executives, analysts and some lawmakers warn that in a U.S. election year, there is a danger of over-regulation. "If we reach September and gasoline prices or food prices are setting new highs, noone knows what Congress would do," one says. That means there is also a risk of long-term damage to the commodity futures industry.

Today, the Onion Futures Act remains in effect. But that has not stopped the price of onions from shooting up an eye-watering 420 percent since 2000.

Lawmakers and Stakeholders Fail To Grasp the Details of the Debate

In 2002, when the U.S. Congress was debating whether to close the "Enron Loophole"—that is, to require that over-the-counter energy markets be brought under the full oversight of the U.S. futures regulator—Republican Trent Lott rose to his feet in the Senate chamber.

Brandishing a dictionary, the senator looked up a definition of "a derivative", a term referring to the complex futures contracts used in the energy markets to hedge the risks associated with holding physical supplies of commodities such as oil and natural gas. The dictionary told him that it was "the limit of the ratio of the change in a function to the corresponding change in its independent variable as the latter change approaches zero".

Mr. Lott turned to his colleagues with a warning: "We don't know what we are doing here. I have serious doubts how many Senators really understand [this] and it sounds pretty complicated to me."

Six years later, it is hard not to conclude that lawmakers are still not as informed as they could be about the issues. That matters, as legislation is now floating around Capitol Hill that could end up forcing significant changes to the mandate of the Commodity Futures Trading Commission, the U.S. commodities regulator.

Bart Stupak, a Michigan Democrat who has introduced legislation, said in May that "excessive speculation" had "inflated oil prices to the point that they are no longer tied to underlying supply and demand"—a claim most economists would struggle to agree with.

Some of the stakeholders in the debate are not helping. A coalition of airline and travel industry associations wrote to Harry Reid, the Senate majority leader, and Nancy Pelosi, the House Speaker, last month claiming that speculators traded 22 barrels of "paper oil"—futures contracts—for every physical barrel of oil consumed. However, Francisco Blanch, commodity strategist at Merrill Lynch, says: "Speculators do not add physical demand or take away physical supply from the market. They do not take away any barrel of oil or bushel of corn from the economy and the only way they can affect spot prices is if they reduce the quantity available for final consumers."

**Editorial: The Onion Ringer**

*The Wall Street Journal*
8 July 2008

Congress is back in session and oil prices are still through the roof, so pointless or destructive energy legislation is all but guaranteed. Most likely is stiffer regulation of the futures market, since Democrats and even many Republicans have so much invested in blaming "speculators" for $4 gas.

Congress always needs a political villain, but few are more undeserving. Futures trading merely allows market participants to determine the best estimate—based on available information like supply and demand and the rate of inflation—of what the real price of oil will be on the delivery date of the contracts. Such a basic price discovery mechanism lets major energy consumers hedge against volatility. Still, "speculators" always end up tied to the whipping post when people get upset about price swings.

As it happens, though, there's a useful case—study in the relationship between futures markets and commodity prices: onions. Congress might want to brush up on the results of its prior antispeculation mania before it causes more trouble.

In 1958, Congress officially banned all futures trading in the fresh onion market. Growers blamed "moneyed interests" at the Chicago Mercantile Exchange for major price movements, which could sink so low that the sack would be worth more than the onions inside, then drive back up during other seasons or even month to month. Championed by a rookie Republican Congressman named Gerald Ford, the Onion Futures Act was the first (and only) time that futures trading in a specific commodity was prohibited, and the law is still on the books.

But even after the nefarious middlemen had been curbed, cash onion prices remained highly volatile. In a classic 1963 paper, Stanford Economics Professor Roger

Gray examined the historical behavior of onion prices before and after the ban and showed how the futures market had actually served to stabilize prices.

The fresh onion market is highly seasonal. This leads to natural and sometimes large adjustments in prices as the harvest draws near and existing inventories are updated. Speculators became the fall guys for these market forces. But in reality, the Chicago futures exchange made it possible to mitigate the effects of the harvest surplus and other shifts in supply and demand.

To this day, fresh onion prices still cycle through extreme peaks and troughs. According to the USDA, the hundredweight price stood at $10.40 in October 2006 and climbed to $55.20 by April, as bad weather reduced crop yields. Then it crashed due to overproduction, falling to $4.22 by October 2007. In April of this year, it rebounded to $13.30.

Futures trading can't drive up spot prices because the value of futures contracts agreed to by sellers expecting prices to fall must equal the value of contracts agreed to by buyers expecting prices to rise. Again, it merely offers commodity producers and consumers the opportunity to lock in the future price of goods, helping to protect against the risks of future price movements.

Tellingly, the absence of that option for onions now has some growers asking Congress to lift the ban. But instead of learning from its onion mistakes, the political class seems eager to repeat them.

**Easy Target, But Not the Right One**

*New York Times*
By Joe Nocera
28 June 2008

So now we know: it's all the fault of those damnable speculators. They're the ones to blame as the price of oil tops $140 a barrel.

It's not our government's fault for failing to come up with a credible energy policy—that can't be it. Nor is the problem the weak dollar, or the voracious energy appetite of the Chinese, or those pesky rebels in Nigeria who are trying to blow up their country's oil pipelines. And it's certainly not the fault of you and me for driving gas-guzzling S.U.V.'s. It has to be those speculators. They are the only villains in sight.

This was "first let's kill all the speculators" week on Capitol Hill, and it was not a pretty sight. On Monday, the House Oversight and Investigations Subcommittee held an 8 hour hearing (!), the sole purpose of which was to decry "excessive speculation." "Have speculators hijacked trading on the futures exchange?" asked the Michigan Democrat Bart Stupak. His answer throughout the day—as he "grilled" an array of sympathetic academics and futures market critics—was a resounding yes.

On Tuesday, the action moved to the Senate, where the Homeland Security and Governmental Affairs Committee held its hearing. "Speculation in the food and fuel markets is not illegal," Senator *Joe Lieberman* of Connecticut conceded, "but that does not mean it is not very hurtful." He continued: "They are artificially inflating the price of food and oil and causing real suffering for millions and millions of people and businesses."

There were yet more hearings on Wednesday, and by Thursday evening, the House had passed, by a wide margin, a bill calling on the *Commodity Futures Trading Commission* to curtail "excessive speculation." Indeed, the C.F.T.C. spent the week being raked over the coals for allowing all this rampant speculation to take place. On Monday afternoon, for instance, Representative John Dingell of Michigan took unseemly glee in going after Walter L. Lukken, the agency's Chairman.

Jabbing his pencil at Mr. Lukken, Mr. Dingell described the founding of the agency as an effort to prevent farmers and consumers from being "screwed" by "those folks in the futures markets."

"Now," he said, "we find that those good-hearted folks in the futures market have figured out how not just to screw the farmers and the consumers in the city, but they figured out how to screw the farmers and the consumers in the city on a whole new product—oil." As Mr. Dingell sneered triumphantly, Mr. Lukken seemed to shrivel in his seat.

Yes, it was wonderful theater, and great blood sport. And it had absolutely nothing to do with the price of oil.

It's not just Congressmen who are railing about speculators, of course. As oil prices have doubled in the last year, I've gotten e-mail messages from readers decrying speculators, who, many believe, are manipulating the futures market. More than once this week, legislators used that same word their constituents were using: "manipulation."

So let's take a closer look at what the speculators' critics are saying. First, despite the loose use of the word "manipulation," that is really not what is being alleged here, at least not in the classic sense. Remember how the Hunts tried to corner the silver market? They bought up silver and took it off the market, thereby creating an artificial shortage. I suppose *OPEC* could do something like that—one could even argue that OPEC does that already—but no mere speculator could.

I can already hear your rejoinder: what about *Enron* and its famous manipulation of energy prices in California? But remember, Enron was manipulating electricity prices, not oil, which was possible mainly because electricity can't be stored. By getting power plants to shut down for hours at a time, Enron was able to create artificial shortages and jack up the price.

Instead, the critics' thesis is that speculators are creating an energy bubble the same way investors created the Internet bubble. As speculative bets on energy have grown drastically in recent years, the sheer amount of money being thrown at energy futures is making those bets a self-fulfilling prophecy. All that money, in other words, pushes prices higher than they would go if the market simply consisted of the actual buyers and sellers of oil.

In addition, because of something called the "London loophole" and the "Enron loophole," which allow speculators to use unregulated exchanges, they can evade the limits of the *New York Mercantile Exchange,* as well as C.F.T.C. scrutiny.

The leading proponent of this theory is a portfolio manager based in the Virgin Islands named Michael W. Masters. When I caught up with him on Thursday afternoon, after his week of testimony, he said that the problem was that institutional investors had stopped seeing energy as a commodity the world relies on and instead saw it as an "asset class" for their portfolios. "I am opposed to thinking about commodities as an asset class," he said.

Several years ago, he continued, he began to notice that increasing cash flows were moving into commodities index funds. This was, he said, "long-only money"—meaning that it was a pure bet that prices would go up. By now, he told me, there is $240 billion in commodity index funds, up from $13 billion 5 years ago. As he also noted in his testimony before Congress, "the prices of the 25 commodities that compose these indices have risen by an average of 183 percent in those 5 years!" He claims that energy prices will fall by 50 percent if the speculators can only be driven out of the futures market.

There are so many holes in this argument I scarcely know where to start. The C.F.T.C. says that some $5 trillion worth of futures and options transaction trades take place every day; can an influx of $240 billion, spread over 5 years, really propel prices upward to the extent that he and others claim? Then there's the fact that the commodities markets don't work like equity markets, where a small amount of trading can lift every share of a company's stock. In commodities trading, every contract has a buyer and a seller, meaning that for every bet that prices are going up, somebody else is betting they are going down. Why doesn't that short interest depress prices?

And what about all those commodities, like coal or barley or sulfur, that don't trade on any futures market but have risen as fast as or faster than oil? Or how about the recent decline in cash flows into many commodity funds—why have prices kept going up if the money has stopped pouring into those funds? My speculator friends tell me that in the last 2 weeks, trading volumes have been cut in half. Indeed, what I hear is that much of the speculative money that remains in the market is betting against higher oil prices.

As for the London and Enron loopholes, I can pretty much guarantee they will be closed soon. There are some eight bills aimed at curbing speculation, and virtually every one of them calls for an end to the loopholes. That is probably a good thing—but I'd lay odds the price will not drop as a result. The loopholes are not the reason prices are going up.

In fact, I'd be willing to go a step further. Even if you eliminated speculation entirely, the price of oil wouldn't fall. Thankfully, no one is proposing to go that far (though Senator Lieberman was toying with the idea), because even Members of Congress understand that futures markets serve a crucial purpose. They help companies hedge their oil prices, and they help energy companies manage their risk, for starters.

The energy speculators I spoke to say that Congress has it exactly backward: the futures market is actually taking its cues from the physical market, where the buyers and sellers of oil do their business. Last week, the Saudis promised to produce an extra 200,000 barrels a day. But it is pricing that oil so high that oil companies are balking at paying for it. The Saudis didn't arrive at their price by looking to the futures market—but if they get that price, it will certainly affect the futures market.

Both speculators and oilmen say that supply and demand is the real culprit. "Our supply is pathetic," said Gary Ross, the Chief Executive of the PIRA Energy Group, and a well-known energy consultant. "Look at the data," he continued. "The world economy is growing by 3.9 percent a year. World oil demand should grow by 2.3 percent just to keep pace. That's an extra two million barrels a day. We don't have it! It's obvious."

I also think there is something else at play. After years of ignoring the rather obvious fact that oil is a finite resource, the world has suddenly become acutely aware of that reality. Everyone in the oil markets is attuned to every little twitch that has the potential to damp supply or increase demand. That's why, for instance, when Libya announced on Thursday that it might cut oil production, oil jumped more than $5. Meanwhile, when Brazil discovers a huge new oil field, the market shrugs. That is not speculation at work—it's market psychology. There's a big difference. If there is indeed a bubble, that's what is causing it.

"Speculators have always been an easy target," said Leo Melamed, the man who founded the futures markets. As *Ron Chernow,* the great business historian put it, "At times in history when you have vast and impersonal forces wreaking havoc in markets, there is always a temptation to villainize someone." Centuries ago, it was Shylock; now it's the speculator and the short-seller.

In his book "The House of Morgan," Mr. Chernow has a description of Herbert Hoover, "moody and isolated," convinced that short-sellers were behind the market's horrendous downturn in 1929. "He came to believe in a Democratic conspiracy to drive down stocks by selling them short," Mr. Chernow writes, adding that Hoover "began to compile lists of people in the bear cabal and even claimed to know they met every Sunday afternoon to plot the week's destruction!"

I wonder whether Mr. Dingell has heard about them.

**Fuels on the Hill**

*New York Times*
By Paul Krugman

Congress has always had a soft spot for "experts" who tell Members what they want to hear, whether it's supply-side economists declaring that tax cuts increase revenue or climate-change skeptics insisting that global warming is a myth.

Right now, the welcome mat is out for analysts who claim that out-of-control speculators are responsible for $4 a gallon gas.

Back in May, Michael Masters, a hedge fund manager, made a big splash when he told a Senate Committee that speculation is the main cause of rising prices for oil and other raw materials. He presented charts showing the growth of the oil futures market, in which investors buy and sell promises to deliver oil at a later date, and claimed that "the increase in demand from index speculators"—his term for institutional investors who buy commodity futures—"is almost equal to the increase in demand from China."

Many economists scoffed: Mr. Masters was making the bizarre claim that betting on a higher price of oil—for that is what it means to buy a futures contract—is equivalent to actually burning the stuff.

But Members of Congress liked what they heard, and since that testimony much of Capitol Hill has jumped on the blame-the-speculators bandwagon.

Somewhat surprisingly, Republicans have been at least as willing as Democrats to denounce evil speculators. But it turns out that conservative faith in free markets somehow evaporates when it comes to oil. For example, *National Review* has been publishing articles blaming speculators for high oil prices for years, ever since the price passed $50 a barrel.

And it was John McCain, not Barack Obama, who recently said this: "While a few reckless speculators are counting their paper profits, most Americans are coming up on the short end—using more and more of their hard-earned paychecks to buy gas."

Why are politicians so eager to pin the blame for oil prices on speculators? Because it lets them believe that we don't have to adapt to a world of expensive gas.

Indeed, this past Monday Mr. Masters assured a House Subcommittee that a return to the days of cheap oil is more or less there for the asking. If Congress passed legislation restricting speculation, he said, gasoline prices would fall almost 50 percent in a matter of weeks.

O.K., let's talk about the reality.

Is speculation playing a role in high oil prices? It's not out of the question. Economists were right to scoff at Mr. Masters—buying a futures contract doesn't directly reduce the supply of oil to consumers—but under some circumstances, speculation in the oil futures market can indirectly raise prices, encouraging producers and other players to hoard oil rather than making it available for use.

Whether that's happening now is a subject of highly technical dispute. (Readers who want to wonk themselves out can go to my blog, *krugman.blogs.nytimes.com,* and follow the links.) Suffice it to say that some economists, myself included, make much of the fact that the usual telltale signs of a speculative price boom are missing. But other economists argue, in effect, that absence of evidence isn't solid evidence of absence.

What about those who argue that speculative excess is the only way to explain the speed with which oil prices have risen? Well, I have two words for them: iron ore.

You see, iron ore isn't traded on a global exchange; its price is set in direct deals between producers and consumers. So there's no easy way to speculate on ore prices. Yet the price of iron ore, like that of oil, has surged over the past year. In particular, the price Chinese steel makers pay to Australian mines has just jumped 96 percent. This suggests that growing demand from emerging economies, not speculation, is the real story behind rising prices of raw materials, oil included.

In any case, one thing is clear: the hyperventilation over oil-market speculation is distracting us from the real issues.

Regulating futures markets more tightly isn't a bad idea, but it won't bring back the days of cheap oil. Nothing will. Oil prices will fluctuate in the coming years—I wouldn't be surprised if they slip for a while as consumers drive less, switch to more fuel-efficient cars, and so on—but the long-term trend is surely up.

Most of the adjustment to higher oil prices will take place through private initiative, but the government can help the private sector in a variety of ways, such as helping develop alternative-energy technologies and new methods of conservation and expanding the availability of public transit.

But we won't have even the beginnings of a rational energy policy if we listen to people who assure us that we can just wish high oil prices away.

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SUBMITTED LETTERS BY HON. BOB ETHERIDGE, A REPRESENTATIVE IN CONGRESS FROM NORTH CAROLINA

**William H. Prestage, President and CEO, Prestage Farms, Clinton, NC**

July 11, 2008

Dear Congressman Etheridge:

Prestage Farms is a producer of swine and poultry in eastern NC. We have been in business for over 25 years and have experienced many ups and downs in the industry. However, we have very strong concerns over various costs currently affecting our business, our customers, and our employees.

At least 70% of the cost to raise livestock is feed itself. The costs of commodities such as corn, soybean meal, and fat, which represent approximately 90% of our feed cost, have been rising at an alarming rate. The additional cost of these ingredients has had a tremendous impact on our company financially, as they will ultimately, the consumer.

The cost for a bushel of corn has increased over 100% since last year, soybean meal over 80% and fat over 68%. The additional cost of these three items alone will be over $225,000,000 to Prestage Farms in 2008. As a result of that, our cost to produce a pound of turkey meat and hog meat will increase by more than 50%.

It is difficult to quantify the impact of rising fuel costs, as increased fuel costs will affect virtually every aspect of our business. Vendors from whom we purchase products are experiencing rising fuel costs and are increasing their product costs to us as a result. Our employees are also feeling the impact of increased fuel cost in commuting, child care costs, and food cost. Directly, the increased cost of fuels increases our cost to haul ingredients and commodities, to haul our livestock, to provide heat to our livestock, as well as increasing our cost to operate machinery and equipment necessary for our production. Our cost of fuel purchases in 2008 alone will increase by approximately $6,000,000 due to increased prices. This does not take into account the additional costs passed through to us by vendors.

Again, the impact of the rising cost of commodities, ingredients, and fuels, is proving to have extremely negative impacts on our industry. Employees, consumers, and businesses alike are in dire need of efforts that will help control some of these issues. I appreciate your efforts to help control and even possibly reverse some of these issues, as they are proving to have such negative impacts on our consumers and businesses.

Sincerely,

WILLIAM H. PRESTAGE,

*President and CEO.*

**Roger F. Mortenson, President and CEO, House-Autry Mills, Inc., Four Oaks, NC**

Dear Congressman Etheridge:

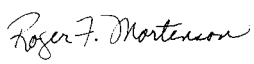
It was a pleasure seeing you last week in Four Oaks. I certainly commend you for your visibility with your constituents. You consistently visit your constituents to learn what their concerns are as well as reporting to us what is going on in the nation's capital. Thank you for your excellent representation.

As a small company, House-Autry Mills is being very negatively affected by increased costs on every side. Our primary products are wheat flour, corn and corn based products. With commodity costs rising seemingly uncontrollably and being influenced by market speculators and speculation, we find ourselves in the position of having had to raise prices to our consumers a number of times over the past months, which only exacerbates the financial stress and strain on the consumer.

So it is with the rising fuel costs, again due in a large part to the speculators and speculation in the cost of oil. Not only affecting consumers directly at the pump, the high fuel costs also increase the cost of food because of the high cost of getting ingredients to our plant as well as increasing the costs of delivering finished products to our customers. As we distribute to 25 to 30 states from our Four Oaks plant, it is becoming almost cost prohibitive to continue at the same level of business, much less trying to expand our sales volume and distribution.

I certainly applaud your efforts to reverse and control some of these issues that are proving so destructive to consumers and companies alike. I look forward to your positive efforts in securing concrete ways to limit cost increases in fuel and in food.

Best personal regards,



ROGER F. MORTENSON,
*President and CEO.*

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SUPPLEMENTAL MATERIAL SUBMITTED BY PAUL N. CICIO, PRESIDENT, INDUSTRIAL ENERGY CONSUMERS OF AMERICA, WASHINGTON, D.C.

July 16, 2008

Hon. BOB ETHERIDGE,
*Chairman,*
Subcommittee on General Farm Commodities and Risk Management,
Committee on Agriculture,
U.S. House of Representatives,
Washington, D.C.

Dear Mr. Chairman:

This letter and its attachments are a response to your request during the July 10, 2008 hearing on the review of legislation amending the Commodity Exchange Act and excessive energy speculation. You requested that I provide additional information relating to a concerning potential relationship between bank borrowing from the Federal Reserve and the corresponding rise of energy commodity prices.

As we said in our testimony, we encourage the Congress to ensure that Federal Reserve monetary policy is not causing higher energy and food costs by providing low cost money to banks to speculate on commodities. The attached graphs show an almost linear relationship between lower Federal Reserve interest rates, increased borrowing by banks and corresponding higher commodity prices. We are concerned that the timing is not coincidental.

The attached graphs include:

Graph 1. Federal Reserve Fund Borrowing (February 2007–June 2008)

Graph 2. Federal Reserve Fund Borrowing (August 2007–July 2008)

Graph 3. Federal Reserve Fund Borrowing vs. Light Crude Oil

Graph 4. Federal Reserve Fund Borrowing vs. Natural Gas

Graph 5. Federal Reserve Fund Borrowing vs. NY Harbor RBOB Gasoline Blendstock

Graph 6. Federal Reserve Fund Borrowing vs. Heating Oil

Thank you for your interest in this matter and we look forward to hearing from you on the response from the Federal Reserve.

Sincerely,

PAUL N. CICIO,
*President.*

**Table 1: Intended federal funds rate Change and level, 1990 to present**

| Date | Change (basis points) Increase | Decrease | Level (percent) |
|---|---|---|---|
| 2008 | | | |
| 30-Apr | ... | 25 | 2 |
| 18-Mar | ... | 75 | 2.25 |
| 30-Jan | ... | 50 | 3 |
| 22-Jan | ... | 75 | 3.5 |
| 2007 | | | |
| 11-Dec | ... | 25 | 4.25 |
| 31-Oct | ... | 25 | 4.5 |
| 18-Sep | ... | 50 | 4.75 |
| 2006 | | | |
| 29-Jun | 25 | ... | 5.25 |
| 10-May | 25 | ... | 5 |
| 28-Mar | 25 | ... | 4.75 |
| 31-Jan | 25 | ... | 4.5 |

**Graph 1: Federal Reserve Fund Borrowing (February 2007-June 2008)**

**Graph 2: Federal Reserve Fund Borrowing (August 2007-July 2008)**

**Graph 3: Federal Reserve Fund Borrowing vs. Light Crude Oil**

**Graph 4: Federal Reserve Fund Borrowing vs. Natural Gas**

**Graph 5: Federal Reserve Fund Borrowing vs. NY Harbor RBOB Gasoline Blendstoc**

**Graph 6: Federal Reserve Fund Borrowing vs. Heating Oil**

SUBMITTED STATEMENT BY NATIONAL COTTON COUNCIL

The National Cotton Council (NCC) is the central organization of the United States cotton industry. Our members include producers, ginners, cottonseed merchandisers and processors, 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 Virginia 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 Peterson for holding this series of very important hearings to review possible amendments to the Commodity Exchange Act (CEA). Since late February, all segments of the cotton industry have felt the impacts of the disruptive and uncertain nature of the New York cotton futures markets. Many of the concerns felt by this industry were conveyed to the Commodity Futures Trading Commission (CFTC) during their April 22 roundtable. In addition, Mr. Andy Weil, then President of the American Cotton Shippers Association (ACSA), presented those concerns during a hearing of Subcommittee on General Farm Commodities and Risk Management.

The NCC would like to take this opportunity to reiterate a number of points and recommendations made by the industry and also stress the importance to of a well-functioning futures market.

Unfortunately, the cotton futures market remains largely 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 many agricultural markets but appears more severe in cotton futures trading. As an example, the synthetic value of cotton futures increased by approximately 31¢ between February 20 and March 4 while the cash price changed by only 4¢. Furthermore, markets continue to be highly volatile. Just in the past 2 weeks, December 2008 futures fell from the low 80¢ range to the low 70¢ range with no significant change in market fundamentals.

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.

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 4 months—producers, along with merchants, have been 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 U.S. cotton farmers lose $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.

The NCC urges 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 merchandising members that call for more transparency in trading and reporting. In addition, CFTC 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 under-

stand 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.

In early June, the CFTC announced several policy initiatives—including a cotton market investigation—aimed at addressing concerns in the agricultural futures markets that were raised at its April 22 roundtable. The NCC remains hopeful that the ongoing probe will yield some definitive outcomes to address the ongoing problems with the cotton futures market. Restoring confidence in the futures market is of the utmost importance to this industry.

Thank you for the opportunity to share our views and concerns.

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SUBMITTED STATEMENT BY UNITED EGG PRODUCERS

This statement is submitted for the record on behalf of United Egg Producers (UEP). UEP is a farm cooperative whose members independently market about 97% of all the shell eggs produced in the United States. UEP commends the Committee on Agriculture for holding comprehensive hearings on legislative proposals affecting the energy futures markets. Like many other farm groups, UEP has been concerned about the recent performance of both agricultural and energy markets.

UEP members have a strong interest in the legislative proposals before the Committee:

- We are exposed to rising energy costs by the nature of our business: Henhouse ventilation systems operate by electric power; trucks that deliver eggs to our customers are diesel-fueled; heat supplied to pullet houses is generated by natural gas or propane; and those producers who grow all or a portion of their own feed require diesel fuel to operate farm equipment. Therefore, rapidly rising energy costs have a significant negative impact on our businesses.
- The futures markets are also important to us as purchasers of feed. Smoothly functioning futures markets for corn, soybean meal and other commodities allow us to hedge our feed costs, which comprise more than half of our total production costs. The health of our businesses is threatened not only by extremely high feed commodity prices, but also by large margin calls that result from the high prices, as well as the well-documented deterioration in cash and futures market convergence.

In the many Congressional hearings that have focused on energy futures markets during the past few months, one question has been asked again and again: How much of the recent increase in oil prices can be attributed to speculation rather than supply-demand fundamentals? The question may ultimately be unanswerable, at least with precision; hearing witnesses' answers varied from none to $65 or $70 a barrel.

Two things seem obvious to us. First, market fundamentals have driven prices upward; one only has to think of growing Chinese and Indian demand and the volatile politics of the Middle East, to name only two factors. Second, it is impossible to believe that the huge inflow of speculative capital, including large amounts of long-only, passively-managed index fund investment, does not exert upward pressure on futures prices.

Some observers minimize the role of speculators by saying that for every long there must be a short. This simplistic statement ignores the central fact of futures markets. The law of supply and demand still applies. Yes, there must be a short for every long, but when demand for long futures positions increases as a result of billions of dollars of new demand for long positions, the price of those positions—*i.e.,* the price the long must pay the short—will rise. The well-documented increase in investment by index funds—nearly all of which by definition are on the long side of the market—seems certain to account for some of the rise in energy and agricultural futures prices.

The traditional role of futures markets is being undermined by excessive speculation by multi-billion dollar funds betting on a price increase in commodities. Commodity futures markets were created for and still exist for the purpose of allowing the producers and consumers of commodities to hedge their risks by fixing their

prices in advance. As these markets became more successful, they have served another important function, price discovery. This has become an enormously important function of the markets because even the millions of primary commodity users and retail consumers have the prices of their purchases determined on the futures markets.

Nowhere is the importance of price discovery more evident than in the price of gasoline. Typically, buyers and sellers of the physical commodity use the price established on the New York Mercantile Exchange as a reference point and make deals on some differential of this price. For the average motorist, this comes as no surprise. When there is an oil price spike in the futures market, it is quickly followed by a boost in the price at his or her local gas station.

Many legislative proposals center on applying fairly traditional rules governing speculation in a stricter manner. The proposals seek to ensure that the Commodity Futures Trading Commission (CFTC) gains additional information about the positions of various market participants, including those in various off-exchange and over-the-counter market venues. Many proposals also seek to apply more rigorously the traditional exchange requirements for large-trader reporting and speculative position limits.

In general, we believe that hedging exemptions should be available only where there is a clear nexus with an entity that is exposed to the price of the underlying commodity in the normal course of its business. A grain elevator that uses futures to manage the risk of offering cash forward contracts to local farmers is undoubtedly hedging. On a much larger scale, an airline that enters a swap agreement to manage jet-fuel costs, with the result that a swaps dealer takes an offsetting, on-exchange position in petroleum futures, is also hedging. A pension fund that invests in an index fund or an actively managed hedge fund is not hedging and the associated on-exchange transactions should not be carried out under a hedging exemption.

We favor legislation that requires the consistent application of position limits to speculators, and provides guidance to the CFTC in differentiating between hedgers and speculators. We would recommend some degree of discretion for the CFTC in applying position limits, to allow for special or unforeseen circumstances.

With respect to specific legislative proposals, UEP supports legislation to achieve the following:

- The CFTC should be provided sufficient budgetary resources and personnel to handle its increasingly important responsibilities. We realize that the actual appropriations cannot be provided in legislation reported by the Committee on Agriculture, but we urge the Committee to work with Congressional colleagues to build support for 'an adequate CFTC budget. We support the request for an additional $27 million and 100 full-time equivalents (FTEs) made last month by the CFTC.
- Exempt commercial markets should be subject to large-trader position reporting and speculative position limits and, if appropriate, other applicable regulations.
- Foreign boards of trade that desire "no-action" letters from the CFTC should be required to maintain large-trader position reporting, speculative position limits, and other regulatory provisions deemed appropriate by the Commission. Granting such "No Action" letters should be a function of CFTC Commissioners, not staff.
- Exemptions from speculative position limits should be available only to legitimate hedgers. If a swap dealer seeks to manage its swap-based risk by taking an offsetting position in the futures markets, the CFTC should review the swap transaction to determine whether it qualifies for a hedging exemption. The exemption should only be granted where an entity is managing a risk that it incurs in the normal course of its business with respect to the underlying commodity being traded in the futures market.
- With respect to index funds, we believe the application of position limits is the appropriate way for Congress to address this issue. We believe any restrictions applied to index funds in energy markets should also be applied in agricultural markets.

With respect to the last point, we urge Congress to avoid any unintended consequences of treating one futures market differently from another. There is some possibility that the application of position limits to index funds in energy markets—which we believe is justified—would provide an artificial inducement for large institutions to shift such investments into agricultural markets if exemptions from position limits continued to be available in those markets. Already, the index funds are a major force in agricultural futures markets and may be exerting upward price pressure there, just as they are in energy markets. Congress should avoid any artifi-

cial incentives for these funds to shift their investments into agricultural markets merely for regulatory reasons. As a general matter, we believe that the rules for index fund and hedge fund investment should be similar across the markets for physical commodities.

UEP appreciates the Committee's consideration of our views.

# HEARING TO REVIEW LEGISLATION AMENDING THE COMMODITY EXCHANGE ACT

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**FRIDAY, JULY 11, 2008**

HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
*Washington, D.C.*

The Committee met, pursuant to call, at 9:08 a.m., in Room 1300, Longworth House Office Building, Hon. Collin C. Peterson [Chairman of the Committee] presiding.

Members present: Representatives Peterson, Holden, Etheridge, Baca, Cardoza, Scott, Marshall, Herseth Sandlin, Cuellar, Costa, Salazar, Ellsworth, Boyda, Space, Walz, Gillibrand, Kagen, Pomeroy, Barrow, Lampson, Donnelly, Childers, Goodlatte, Moran, Hayes, Graves, King, Neugebauer, Boustany, Kuhl, Foxx, Conaway, Fortenberry, Smith, and Walberg.

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

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

The CHAIRMAN. The Committee will come to order. I appreciate the Members being here on a Friday when we could be someplace else.

Mr. CONAWAY. I could be in Texas.

The CHAIRMAN. That's right. And we appreciate the witnesses being here with us today.

This is the third day of hearings that we have been having regarding all of these issues and bills that we have had Members of Congress come in and explain their proposals. And we had a good discussion yesterday with the panels in the various areas we discussed yesterday. Today we will examine the foreign boards of trade; the second panel, margins; and the third panel we will kind of tie everything else up that we couldn't find a category for.

We have Members that have obligations, and so I am going to be—as opposed to yesterday, I am going to impose the 5 minute rule with some strength today.

Mr. CONAWAY. You have a gavel.

The CHAIRMAN. So we would encourage everybody to be mindful of that, and hopefully we can move through this in an expeditious fashion.

[The prepared statement of Mr. Peterson follows:]

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

Good morning and welcome to today's hearing.

Today marks the last day of three hearings this week to review legislative proposals to amend the Commodity Exchange Act.

We have three full panels today and a lot of ground to cover, so I will keep this very brief and not repeat what I said the last 2 days.

Wednesday we heard from six of our House colleagues who have introduced bills that would amend regulation of commodity futures markets. Yesterday and today, we will hear from stakeholder groups about these and other legislative proposals, as well as the major issues currently surrounding commodity futures and options markets.

What we intend to do is have each panel examine one of these subjects in detail. Today's three panels will look at:

- Foreign Boards of Trade;
- Margins; and
- Miscellaneous/General.

Today's witnesses will hopefully shed some light on these topics and how legislation that has been introduced would affect them. Some groups, of course, have vested interests in more than just one area, and that will be reflected in their broader written testimony submitted for the record. But with so much to get to today, we will try and keep this as focused as possible.

At this time, I now yield to the Ranking Member of the Committee, Mr. Goodlatte for an opening statement.

The CHAIRMAN. So we welcome the witness to the first panel on the foreign boards of trade: Mr. Mark Young from the Futures Industry Association; Mr. David Peniket, President and Chief Operating Officer of ICE Futures Europe, London, U.K.; Mr. Gerry Ramm—Ramm is it?

Mr. RAMM. Yes.

The CHAIRMAN.—from the Inland Oil Company on behalf of the Petroleum Marketers Association; and again, Mr. Michael Greenberger, who was with us yesterday, from the University of Maryland School of Law. And we welcome the panel.

Your full statements will be made part of the record. We would encourage you to try to limit your remarks to 5 minutes, and, if possible, talk to us in terms that we can understand, which may not be possible.

So, Mr. Young, you are on.

## STATEMENT OF MARK D. YOUNG, J.D., PARTNER, KIRKLAND & ELLIS LLP, WASHINGTON, D.C.; ON BEHALF OF FUTURES INDUSTRY ASSOCIATION

Mr. YOUNG. We will try.

I am Mark Young. I am actually a Partner in the law firm of Kirkland & Ellis, and I am appearing today on behalf of our client, the Futures Industry Association. I am a pinch-hitter for John Damgard, the President of the Futures Industry Association, who regrets he is not able to be here. But like John, I have been involved in every CFTC reauthorization since 1978. I also teach a derivatives course at the Georgetown Law School and have for many years, even before Mike Greenberger joined the CFTC. So I am very familiar with the history and law being discussed in this hearing.

FIA represents the interests of the U.S. futures industry as a whole. And especially the firms that broker trades for customers. Our member firms execute and clear orders for customers world-

wide. That business is jeopardized, we believe inadvertently, by the legislative proposals you are considering in the foreign board of trade area. FIA asked this Committee in any legislation you consider to work with us to remove this threat without harming market surveillance transparency in any way.

Before discussing what is called the FBOT issue, I want to make two quick points. First, FIA fully appreciates the serious economic challenges high energy prices create. These prices are hurting real people in a real way. Did the futures markets cause those prices or merely serve as the vehicle delivering those prices? Were futures the message or the messenger? At this point we believe futures were the messenger. But it would be imprudent to reach any firm conclusion before the CFTC completes its analysis of this question.

For now FIA looks forward to reviewing the CFTC's findings. We will not, and we believe others should not, prejudge that verdict one way or the other.

Second, many of you have asked in the last couple of days about the term "excessive speculation." The recent history of that term is instructive. From 1922 until the year 2000, the Commodity Exchange Act stated that preventing excessive speculation was a major reason futures regulation was imperative. In 2000, however, Congress repealed that finding. Instead, the statute now states that futures markets serve the national public interest, "by providing a means for managing and assuming price risks, discovering prices and disseminating pricing information through trading in liquid, fair and financially secure trading facilities."

Congress found that assuming price risks, in a word speculating, enabled futures markets to serve the public interest. The importance of that modern finding seems to have been lost by some in the current debate.

What isn't lost is that every witness before you has opposed price manipulation. FIA is no exception. Price manipulation robs the futures markets of their ability to serve the public interest. Congress wisely granted the CFTC vast powers to detect and deter price manipulation. The key to those powers is effective and intensive CFTC market surveillance.

At its core the FBOT issue is all about market surveillance. Sometimes two exchanges compete to list the same product. When they do, market surveillance is more difficult, even with two U.S. exchanges, because it requires seeing trading activity in two markets, not just one. And when that trading activity is being conducted on a foreign market with a foreign regulator, the CFTC must coordinate with those foreign officials in order to conduct effective market surveillance.

This market surveillance challenge is a two way street. Again, that is a point I don't believe that we have heard discussed in these hearings. It applies when a foreign exchange tries to compete with a dominant U.S. exchange and when a U.S. exchange tries to compete with a foreign exchange. This challenge requires cooperation. No exchange, whether in the U.S. or in a foreign jurisdiction, should be subject to the dictates of two separate regulators. Coordination by the CFTC and what the statute calls foreign futures authorities is therefore essential.

The FIA supports legislation to address both sides of this street. We want the CFTC to have access to any and all trading data it needs to make informed market surveillance judgments. We recognize that foreign regulators have the same legitimate concerns about trade on U.S. exchanges that compete with foreign exchanges. In that instance the statute should call for the CFTC's cooperation with the efforts of its foreign counterpart. This two way street approach will lessen the likelihood that legislation in this area will spark trade war-style retaliation. FIA is extremely concerned about that prospect because it could cause foreign exchanges to avoid CFTC regulation by walling out order flow from U.S. firms.

That reaction would threaten our firms' ability to serve their customers from the United States. The result could be a shift in brokerage firm business to overseas affiliates and the loss of jobs. That shift would be even more likely if the U.S. FCM becomes legally responsible for a foreign exchange's compliance with CFTC mandates, as some legislation now proposes.

The FIA thanks you, Mr. Chairman and Members of the Committee, for your continued interest in these issues. Your hearings this week have been fair and informative. As your deliberations continue, FIA will help you in any way we can. We look forward to answering your questions.

[The prepared statement of Mr. Young follows:]

PREPARED STATEMENT OF MARK D. YOUNG, J.D., PARTNER, KIRKLAND & ELLIS LLP, WASHINGTON, D.C.; ON BEHALF OF FUTURES INDUSTRY ASSOCIATION

Mr. Chairman and Members of the Committee, I am Mark Young, appearing on behalf of the Futures Industry Association. FIA appreciates the opportunity to present its views to the Committee on the pending legislation to address futures regulation and energy prices.

FIA regular member firms are registered with the Commodity Futures Trading Commission as futures commission merchants ("FCMs"). FIA's FCM member firms execute customer orders for and provide the financial guarantees underwriting more than 90% of the futures contracts traded on U.S. exchanges. FIA member firms also play a substantial role in executing and clearing orders for customers world-wide in futures contracts traded on non-U.S. exchanges. As the leading trade association for the U.S. futures industry, FIA and its member firms have an acute interest in the many legislative proposals you are considering.

FIA has a long record with this Committee. We have supported every legislative reform of futures regulation dating back to the Commodity Futures Trading Commission Act of 1974 as well as each Reauthorization of the CFTC since 1978. As in the past, FIA is committed to working with this Committee on constructive legislation to modernize regulation and adapt to the ever quickening pace of change in futures trading around the world.

While I suspect FIA, led by John Damgard, is well known to many Members of this Committee, I am sure I am not as well known. I am a Partner in the law firm of Kirkland and Ellis, LLP in the Washington, D.C. office. In 1977, I joined the CFTC's legal staff when I graduated from law school. I then moved to Kirkland in 1982. I have represented clients in every CFTC reauthorization from 1978 to 2008. I now represent FIA on a variety of legislative, litigation and regulatory matters. I represent other clients as well on a variety of regulatory and litigation matters. I do not now represent any U.S. futures exchanges or foreign futures exchanges. Also, since 1991, I have taught a course in Derivatives Regulation as an Adjunct Professor at the Georgetown University Law Center.

FIA and its members have long believed that futures market price integrity is a paramount concern. FIA does not support higher prices or lower prices on any market. FIA does support having prices discovered openly and competitively on what the Commodity Exchange Act calls, "liquid, fair and financially secure trading facilities."

In 1974, this Committee described the Commodity Exchange Act as a "comprehensive regulatory structure to oversee the volatile and esoteric futures trading complex," a description the U.S. Supreme Court later called an "apt[] characteriz[ation]." [1] Amending this complex structure, under even the best of circumstances, can be a difficult challenge. FIA thanks this Committee for your thorough and thoughtful approach to deliberating on the benefits and costs of the many different legislative proposals before you.

FIA views each legislative proposal through the lens of seven basic principles.

1. Futures trading serves the congressionally-endorsed national public interests in commodity price risk management and commodity price discovery. Price manipulation robs futures markets of their ability to serve those public interests.

2. The Commodity Futures Trading Commission now has vast powers to prevent price manipulation, ranging from position limits and vigorous enforcement actions to transparent market surveillance and emergency powers. **The CFTC is an effective agency; it needs additional resources more than it needs additional powers.**

3. Speculators are essential for futures markets, as the Supreme Court and many commentators have found.[2] Without speculators, U.S. futures markets would not serve the national public interest. **Speculation is not price manipulation.** Those who claim it is would also equate oxygen with air pollution.

4. Congress should not enact legislation that would create disincentives for futures business to be conducted through U.S. firms and on U.S. markets, which could cost U.S. jobs. Congress should also not enact legislation that would hinder the CFTC's market oversight and price transparency.

5. The forces of globalization and technological innovation are linking economic and financial activities world-wide more every day. No legislation could repeal that market reality.

6. Loopholes are a misnomer. Congress made many deliberate and realistic policy choices from 1982 to 2000, many of which originated in this Committee. Each was intended to serve the public interest, not any special interest. Those choices have served the public interest well, resulting in strong growth, more transparency and less financial risk in U.S. derivatives markets.

7. The CFTC's legal authority over U.S. futures exchanges, traders and firms is and must be greater and more direct than its legal authority over foreign futures exchanges, traders and firms. **International cooperation and coordination is therefore an essential component of effective market surveillance for global markets.**

Along with other financial services trade associations, FIA has provided a list of measures Congress should enact to deal with the current market situation. Those recommendations are included as *Appendix A.* For this hearing, the Committee has grouped the issues presented in the pending legislative proposals into six categories. FIA's thoughts on each area follow. We emphasize the foreign board of trade issue because it is the primary area of concern to the clearing firms that comprise our core membership.

**Foreign Boards of Trade**

*Background*

In 1982, Congress determined that futures contracts traded on an exchange "located outside the U.S."—called a "foreign board of trade"—would be excused from the requirement that futures contracts in the U.S. must be traded on a CFTC-approved exchange. That requirement remains the law today unless a statutory or regulatory exclusion or exemption is applicable. In 1982, Congress also specified that the CFTC could not directly regulate foreign boards of trade or their operations. For well over a decade, this provision was non-controversial and applied in a legally cer-

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[1] *Merrill Lynch* v. *Curran*, 456 U.S. 353, 355–356 (1982).

[2] *Merrill Lynch* v. *Curran*, 456 U.S. at 390 (speculators play a "crucial role in an effective and orderly futures market"); ECONOMIST, *"Don't blame the Speculators,"* July 5–11, (at 15–16 ("speculators provide a vital service"); Robert Samuelson, *"Lets Shoot the Speculators,"* NEWSWEEK, July 7–14, 2008 ("What makes the futures markets work is the large number of purely financial players—'speculators' just in it for the money—who often take the other side of hedgers' trades."); Richard W. Rahn, *"Greedy Speculators,"* WASHINGTON TIMES, June 25, 2008 at A22 ("There are many . . . market speculators who provide liquidity to the market and fill the void if the numbers of short and long hedgers do not match up."); J. Nocera, *"Easy Target, But Not The Right One,"* NEW YORK TIMES, June 28, 2008 at B1.

tain atmosphere: an exchange was considered to be "located" where its trading floor was located and U.S. customers accessed foreign boards of trade without incident.

In recent years, matching engines, trading terminals, servers and web access allowed any exchange anywhere in the world to access U.S. customers directly. Because issues were raised about whether these developments affected where an exchange was "located," the CFTC and its staff developed a no-action approach. Through the no-action process, the CFTC was able to condition the ability of a foreign board of trade to conduct business with firms and customers in the U.S. One important condition is the level of cooperation the CFTC could receive from a foreign board of trade's foreign regulator, what the CEA defines as a "foreign futures authority." To date, the CFTC's website lists 20 of these No Action letters issued to foreign boards of trade.

As commodity markets have become more international in scope and electronic trade execution mechanisms have become predominant, U.S. and foreign exchanges have begun some level of direct competition. U.S. futures exchanges have attempted to engage in direct competition with certain foreign futures exchanges and foreign exchanges have attempted to engage in direct competition with certain U.S. exchanges. For example, in recent years the Chicago Board of Trade offered replicas of the German Bund, Bobl and Shatz futures contracts which trade successfully on EUREX, the German-Swiss Exchange. The New York Mercantile Exchange also trades a Brent Oil futures contract which is a cash-settled version of the same contract which first traded on what is now ICE Futures Europe. Competition is a two way street. ICE Futures Europe also has listed and trades a cash-settled clone of the bellwether WTI crude oil futures contract traded at NYMEX.

FIA strongly supports direct competition among trading facilities both within the U.S. and globally. Competition leads to more liquidity, lower trading costs, tighter spreads, and more innovation. It does, however, complicate market surveillance. It is easier to know who is trading what futures contracts on one exchange, than on multiple exchanges. It is also easier for a single dominant designated contract market to discharge its statutory duty to prevent manipulation on its own market without having to worry about trading in the same commodity on the market of its competitor, the "challenger" exchange. The CFTC has determined that direct competition is important to promote and that the agency itself will bridge the gap in market surveillance among different exchanges trading the same product when these instances of direct competition arise. FIA has endorsed the CFTC's determination and actions to promote exchange competition.

Competition does promote innovation. For example, in response to the ICE Futures Europe decision to list a NYMEX-replica WTI crude oil futures contract and the immediate success ICE experienced through electronic trading in a contract that previously could only be traded on the NYMEX trading floor, NYMEX accelerated its efforts to allow electronic trading for its WTI contract. In response, the CFTC has taken a number of proactive steps, with the cooperation of ICE's regulator, the UK Financial Services Authority, to make sure that the CFTC's market surveillance picture for both markets is clear and transparent. Again, FIA endorses the measures the CFTC has implemented and commends the agency for its leadership and initiative.

*Current Proposals*

We understand that many want to codify in the CEA the CFTC's market surveillance protocols where a foreign-based and regulated exchange attempts to compete with a U.S. exchange for market share in a particular futures contract. FIA supports that goal. **Competition should not compromise market surveillance.** When two exchanges, no matter where located, compete for trading volume in the same product, the CFTC has heightened market surveillance responsibilities and its traditional market surveillance tools need to be adjusted to make sure that the CFTC has any and all data to prevent price manipulation or other major market disturbances.

As this Committee understands well, with most CEA proposals it is particularly important to target the legislative language to address the specific problem at issue and to avoid triggering legal and business consequences that would undermine the intended policy goal or have other unintended repercussions. In this instance, it is essential that any proposal adopted by the Committee not unintentionally harm the CFTC's efforts to enhance its surveillance capabilities by pushing more market activity to less transparent venues where the trading data the CFTC may need would not be readily available.

FIA has reviewed the pending proposals and our list of concerns with each proposal is found at *Appendix B* to this testimony. Overall, **FIA fears that the proposals in the FBOT area that have been introduced to date would inadvert-**

**ently harm both the CFTC's ability to prevent manipulation and the competitiveness of U.S. brokerage firms, while potentially leading to trade-war type retaliation from foreign governments against U.S. exchanges.** Some of these proposals are drafted in a circular manner so that only foreign exchanges otherwise excused from CFTC oversight by statute would be subject to the heightened surveillance requirements. Other proposals enable FBOTs to evade the contemplated mandated CFTC regulation of FBOT self-regulatory operations by simply refusing to deal with U.S. traders and firms, while welcoming the business of any overseas affiliates of these same traders and firms. This has happened before in the context of security futures products and other trading instruments. In fact, some U.S. clearing firms have moved or may be compelled to move their operational and processing facilities out of the U.S. for just this reason. The results? No direct CFTC transparency for these FBOT trades, leading to increased manipulation risk and increased systemic financial risk on the clearing side, and a weakened business base for U.S. traders and firms (which creates a disincentive to even start such a business in the U.S.).

FIA also believes that any legislation in this area should be symmetrical because competition is global and U.S. exchanges do try to wrest market share from foreign boards of trade in various products, a competitive trend we hope will continue. Foreign futures authorities have as much interest in preventing price manipulation in their jurisdictions as the CFTC does here. None of the introduced proposals addresses this market and regulatory reality.

As mentioned earlier, FIA shares the policy goals of many of the introduced FBOT proposals: to enhance CFTC surveillance where warranted to deal with competition among foreign and U.S. exchanges in energy futures trading and to prevent market manipulation. To achieve those objectives, FIA recommends that the Committee consider the following type of provision:

> When a foreign board of trade lists for trading an energy futures contract that is linked to the settlement price of an energy futures contract trading on a U.S. futures exchange (or *vice versa*) and when the CFTC (or its foreign regulatory counterpart) believes enhanced market surveillance is necessary or appropriate, then the CFTC and its foreign counterpart should immediately consult on, develop and implement heightened surveillance measures to prevent price manipulation and ensure transparent, coordinated market surveillance.

This approach will not only codify and strengthen the process and procedures the CFTC already has implemented with respect to ICE Futures Europe and its coordinated efforts with the FSA, it would build upon the CFTC leadership in this area to promote international consultation and coordinated regulatory responses. We would be leading the world in a common and important mission—the prevention of price manipulation any time, anywhere. We would not be telling the world how that mission must be accomplished or that every CFTC or U.S. exchange requirement must be replicated in every instance. We would be leading, not dictating.

FIA also is very concerned that some legislative proposals in the FBOT area would operate to impose prohibitions on U.S. futures commission merchant firms that accept and execute customer orders on FBOTs. Unintentionally and inadvertently, these proposals would make U.S. firms liable if an FBOT fails to comply with U.S. law. They could also be read to allow customers to sue U.S. firms to void or rescind foreign futures contracts if the FBOT fails to comply with the CFTC-imposed regulatory conditions. **When executing and clearing orders for U.S. or foreign customers, U.S. FCMs should not be guaranteeing the regulatory compliance of FBOTs.** Specific statutory safe harbors and exemptions are needed to prevent CFTC-registered professionals from bearing the legal risk of FBOT noncompliance. Otherwise investment banks and other clearing firms will simply and sensibly decide to run their futures brokerage and clearing businesses through overseas affiliates to avoid that potential liability.

The foreign board of trade issue is vitally important to the future commercial viability of the U.S. FCM community which comprises the core of the FIA's membership. We would be happy to consult with the Committee and its staff on specific legislative language to achieve the objectives of much of the FBOT legislation proposed to date without the adverse consequences outlined above.

*Swaps: Treating Energy Commodities Like Agricultural Commodities*

Under the Commodity Futures Modernization Act of 2000, Congress prescribed different levels of CFTC oversight and regulation for different trading systems, different market participants and different commodities. Generally, Congress determined that trading on multilateral trading facilities, where many market participants may execute trades with other market participants (so-called "many to many"

markets), replicated the trading structure of traditional futures trading pits and should not be excused from CFTC regulation. Also trading among only Eligible Contract Participants, essentially well-capitalized, sophisticated or regulated entities, might not require full CFTC regulation and oversight because each ECP would be capable of protecting itself. And transactions in financial, energy and metals commodities did not implicate the same historical CEA regulatory concerns about market manipulation as did futures on agricultural commodities, which are the only commodities subject to CFTC-set speculative limits for futures trading on an exchange. Building on those concepts, Congress extended legal certainty to non-agricultural commodity transactions among ECPs by excluding or exempting those transactions from the CEA when the transactions were not executed on a trading facility.[3]

Agricultural options and swaps transactions, however, may still be exempted from the CEA's exchange-trading requirement, among other regulatory provisions, under a CFTC exemption found in Part 35 of its Rulebook and adopted under Section 4(c) of the CEA, as enacted in 1992. Under the Part 35 rules, non-standardized and non-fungible derivatives transactions among Eligible Swap Participants (again, well-capitalized, sophisticated parties) are generally exempt from the CEA unless traded on a multilateral transaction execution facility or submitted to a futures-style clearing system. These otherwise exempt agricultural transactions are still subject to the CEA's anti-fraud and anti-manipulation prohibitions.

The CFMA exemptions and exclusions in the energy area represented an attempt statutorily to increase price transparency and remove systemic financial risk in over-the-counter energy transactions. And those provisions have worked as intended. ICE and other market innovators have developed methods of increasing price transparency for energy swaps in less than fully multilateral electronic trading systems. It is uncertain whether those swaps would be eligible for exemption under Part 35. What is certain is that none of those energy swaps could be subject to a futures-style clearing system unless the CFTC adopted a new exemption. Treating energy commodity swaps like agricultural commodity swaps therefore would likely diminish price transparency and increase financial risk for these transactions.

In the 2008 Farm Bill, Congress addressed the legitimate concern that exempt energy transactions under Section 2(h) that are traded electronically and develop into significant price discovery transactions should be regulated more like futures contracts than Congress envisioned in 2000. Once full implemented by the CFTC, this reform will enhance price transparency and market oversight. Its valuable benefits will be lost, however, if energy commodities are treated in the same ways as agricultural commodities and removed from the transactions eligible for exemption under Section 2(h)(3) of the CEA. Like most quick fixes under the CEA, equating energy commodities with agricultural commodities will disserve the public interest. FIA would not recommend its adoption or the approval of any substantive amendments to CEA §§ 2(g) and 2(h). Instead, the reforms in the farm bill should be allowed to take full effect and monitored to determine whether any adjustment is warranted in the near future.

*Resources for the CFTC*

FIA strongly supports the proposals for additional resources for the CFTC, including at least 100 new CFTC employees. Those numbers are commensurate with the CFTC's scope of responsibilities and ever expanding authority in a global and changing market place. The bulk of the CFTC's new resources we would expect to be used to hire attorneys in the Enforcement Division to investigate and root out any alleged price manipulations the CFTC staff may uncover. Manipulation should not be tolerated and enforcement actions for past misconduct are the best means to deter future misconduct.

*Pension Funds and Index Trading*

FIA strongly opposes banning any collective investment vehicles, whether they are pension funds, mutual funds, commodity funds or hedge funds, from participating in futures markets. When the funds' professional trading managers determine it is in the best interests of the funds' investors or beneficiaries to diversify their portfolio by trading in futures markets, that new speculative capital and liquidity should not be shunned. The CFTC is wisely investigating to determine whether index traders or any one else has engaged in price manipulation. FIA has every confidence

[3] This summary oversimplifies the web of CEA exclusions and exemptions enacted in 2000. But it captures the essence of CEA §§ 2(c), 2(d), 2(e), 2(g) and 2(h). Notably, parties engaged in exempt transactions in energy commodities under section 2(h) could still be subject to CFTC prosecution for energy price manipulation.

that the CFTC (along with staff from other, less directly interested, Federal agencies) will analyze the right data and will make public its conclusions on or about September 15, 2008. FIA will be interested to evaluate the Commission's analysis under that accelerated time table. Until the facts are known and analyzed, however, FIA would urge all interested parties not to pre-judge the price effects of index trading, swap dealer net offsets in futures or pension fund activities.

*Speculative Limits*

Some observers believe that swap dealers should not be considered to be hedgers when they enter into futures market transactions to offset the price risk of their swap transactions with non-physical commodity counterparties. To the extent the CFTC study will consider this issue, FIA would withhold final judgment. But it seems to make no difference from the perspective of the swap dealer whether its futures position is designed to manage a price risk incurred with a physical counterparty or a financial counterparty. Price risk is price risk. Swap dealers in energy commodities use futures to reduce their net market price risk on transactions with financial and physical counterparties. If a swap dealer entered into a long swap transaction in crude oil with a notional amount equal to10 futures contracts with a financial counterparty and then entered into a short swap transaction in crude oil with a notional amount equal to five futures contracts with a physical counterparty, the dealer could then go short five crude oil futures contracts on NYMEX to manage its net outstanding price risk. Some proposals would disallow treating the dealer's five short futures position as a hedge; instead those proposals would insist the dealer has a five short speculative position in futures, a result which distorts both the economic reality of the swap dealer's risk and any CFTC surveillance of that position. That approach also could make it more costly for the dealer to margin its futures position (a cost the dealer would likely pass along to its swaps counterparties).

The better way to handle this situation is to allow the CFTC as well as the NYMEX and other exchanges to establish position accountability standards and to look behind the positions when appropriate to see whether the swap dealers or other large traders are engaged in any transactions that would raise surveillance concerns, without worrying about the classification of a position as hedge or speculative. Current law and DCM core principles accomplish that kind of flexibility. Indeed, under NYMEX rules, the hedge *versus* speculation classification only really matters for position limit purposes during the last three trading days in every contract when speculative position limits first become applicable.

*Margin*

U.S. futures exchanges should set margins, not the U.S. Government. Exchanges and their clearing entities set margins to balance credit risk considerations against other market interests. It is a delicate business judgment that goes to the heart of exchange operations and should be left to the exchanges. In the context of crude oil prices, there is no evidence that NYMEX has abdicated its authority in any way in this area. To the contrary, from January 2, 2007 through July 3, 2008, NYMEX has increased its margin for WTI crude oil futures for non-member speculators by about 270% in absolute terms and about 50% when compared to the notional amount per contract.

**Conclusion**

Record high gasoline prices are creating challenges and hardships in our national and international economy. If FIA believed that some reform to futures regulatory surveillance practices would reduce those challenges and hardships, we would not hesitate to recommend those reforms. But FIA is not aware of any proposed change to the CEA that is likely to result quickly, automatically and permanently in a decline in the price of crude oil. We are aware of statutory proposals that would substantially and adversely affect U.S. futures firms and markets, price transparency, systemic risk, and competition. These proposals threaten the viability of many services our member firms now provide to customers in the U.S. and overseas. Those proposals should not be adopted by this Committee and Congress.

FIA respectfully requests that the Committee continue to proceed with caution in considering the pending proposals. We look forward to working with the Committee and its staff to fashion meaningful, realistic and targeted legislation to enhance market surveillance for energy futures markets and to strengthen the CFTC's regulatory muscle over the ever changing dynamic of futures trading activities.

APPENDIX A

**What Congress Should Do**

- Congress should call on the President to immediately send a request for emergency appropriations to allow the CFTC to increase oversight, improve the Commission's information technology, and hire at least 100 new full time employees.
- Congress should instruct the Commission to add at least 100 new full time employees in order to increase surveillance of the market, improve enforcement and otherwise carry out the purposes of the Act.
- Congress should require the CFTC to obtain all necessary market surveillance information to prevent market manipulation.
- Congress should require the CFTC to report to Congress regarding the effectiveness of its expanded information-sharing arrangement with the FSA, and the results of its review of the scope of commodity index trading in the futures market, and its recommendations for any changes to its authority or rules, including any modifications to the Commitment of Traders reports as necessary to provide increased transparency in energy derivative markets.
- Congress should instruct the Commission to undertake a comprehensive report, in conjunction with other futures and options regulators world-wide, relating to differences in regulatory regimes worldwide as well as the role of institutional investors, speculators and other participants in the markets.

APPENDIX B

**Futures Industry Association—Concerns Relating to Foreign Board of Trade ("FBOT") Legislative Proposals**

1. H.R. 6284 (Mattheson), H.R. 6334 (Etheridge), S. 2995 (Levin), S. 3044 (Reid), S. 3129 (Levin), S. 3130 (Durbin)—CFTC may grant § 4(a) relief only for FBOT with comparable regulation and willing to submit trading data to CFTC.

(a) "Located outside." Applies only to foreign boards of trade which, by definition, are located outside the U.S. and therefore do not need § 4(a) relief. Because FBOTs need no § 4(a) relief the provision is ineffective and self-defeating.

(b) "Cash-settled." Applies only to FBOTs "with respect to an energy commodity that is physically delivered in the U.S." FBOT contracts that are cash-settled would not be covered by the provision. ICE Futures Europe's WTI futures contract is cash-settled and does not call for physical delivery of any energy commodity.[1]

(c) Attempts to impose direct CFTC regulation on FBOTs in a number of areas. In response and to avoid duplicative regulatory oversight, FBOTs are likely to close off foreign markets from U.S. market participants and firms. FBOTs will simply refuse to take orders from U.S. firms and traders. FBOT business may not suffer; firms and traders will continue to trade on the FBOT, but will trade through their overseas affiliates.

(d) If FBOTs are made subject to affirmative U.S. statutory requirements, U.S. FCM firms could be liable under § 4(a) for an FBOT's non-compliance because of the way § 4(a) is structured. FCMs should not be insuring FBOT compliance with U.S. law.

(e) No coordination role provided for foreign futures authority with jurisdiction over the FBOT.

2. H.R. 6341 (Van Hollen)—Disqualifies boards of trade from being considered to be foreign if they have U.S. ties and trade SPDCs in energy.

(a) Harms CFTC Surveillance Transparency. Any FBOT could avoid U.S. jurisdiction by not affiliating with an entity in the U.S. or not having any infrastructure in U.S. FBOTs could set up matching engines outside the U.S., with servers outside the U.S. and no direct U.S. presence. FBOTs would not need

[1] H.R. 6349 (Marshall) is substantially similar to the six enumerated bills except it does not have the physical delivery limitation. It would apply if an FBOT's energy contract refers to the price of a physically delivered energy contract traded on a U.S. exchange and the contract contemplates a "primary physical delivery point" in the U.S. This formulation would allow CFTC regulation to apply to FBOT contracts that are cash-settled, although the concept of a primary U.S. delivery point is not well established and may not be easy to apply in all circumstances. Other than cash-settlement, H.R. 6349 raises all of the same issues as the six other bills listed.

any CFTC relief. CFTC would lose all possible leverage in trying to obtain surveillance information.

(b) If CFTC determines an exchange with U.S. ties trades a Significant Price Discovery Contract (a new statutory term designed to serve a very different purpose) in any energy commodity, then that contract becomes illegal to trade in the U.S. unless the FBOT becomes a DCM. Making illegal a contract that others are using for price discovery—theoretically world-wide—will harm the price discovery process and may cause serious commercial harm in the energy markets.

(c) It is unclear how to apply the SPDC criteria from the farm bill to an international market. The SPDC criteria were developed to discern price discovery contracts in the U.S., not in overseas markets. Is the CFTC supposed to make a national or international SPDC determination?

(d) Would encourage foreign exchanges to bar U.S. traders and firms from participating in their markets. Congress may want U.S. parties to participate in energy price discovery rather than leave price discovery just to parties in the Middle East and other parts of the world.

(e) Requires ICE Futures Europe to become a U.S. designated contract market. Could spark trade-war style retaliation.

3. H.R. 6330 (Stupak)—Makes illegal non-DCM energy futures if delivery point in U.S. or "transacted" on a terminal in U.S.

(a) Would not apply to cash-settled transactions on an FBOT.

(b) Exchanges now rely less on dedicated terminals for trading. Modern technology and web-access make trading easier to access from anywhere in the world. FBOT do not need to have terminals in the U.S. If FBOTs don't have terminals in the U.S., the CEA doesn't apply to those FBOTs' contracts.

(c) Excuses an energy contract from coverage under the CEA unless it calls for delivery point in the U.S. or is transacted on a U.S. terminal. An FBOT could list a cash-settled energy contract and allow U.S. traders access from websites in the U.S. and not be subject to the CEA. May actually cut back on CFTC authority, making transparency and market surveillance harder to achieve.

(d) Misapprehends that CFTC FBOT no-actions have relied on Section 4(c) exemptions (which bill seeks to nullify absent public comment). No-actions are not 4(c) exemptions.

4. H.R. 6130 (Barton)—Requires CFTC within 6 months to determine whether to adopt a rule regarding how the CFTC determines a foreign futures authority regulates its exchanges and markets in a way comparable to the CFTC.

(a) Developing regulatory standards for determining comparability in different regulatory structures may limit CFTC discretion. But providing notice to market participants and FBOTs of the factors the CFTC would take into account in making a comparability determination may not be problematic.

(b) May remove CFTC flexibility by requiring FBOTs to have certain specific regulatory tools to achieve comparability. Better approach would be to determine whether anti-manipulation protections are adequate and how well sharing of surveillance data on competing contracts could work.

5. H.R. 6279 (Chabot)—Same as bills covered under Part I above, but adds that FBOT margin requirements must be comparable to U.S. and "sufficient to reduce excessive speculation."

(a) DCMs in U.S. have considerable flexibility in imposing margin, as they should. They operate under core principles subject to CFTC oversight.

(b) Under U.S. law, margin is not generally designed to curb excessive speculation. Margin is largely a credit risk issue. FBOTs should not be held to a different, higher standard.

6. H.R. 6372 (Hill)—No board of trade may be an FBOT if it has a U.S. affiliate, trades a commodity other than an exempt commodity or trades a significant price discovery contract.

(a) No "U.S. affiliate" test artificially restricts cross-border exchange mergers with U.S. entities. Why limit the commercial maneuverability of U.S. trading facilities when foreign counterparts are not similarly restricted? Also allows board of trade a fairly painless way to evade U.S. law.

(b) Energy and metals are exempt commodities. Trading in those kinds of commodities would be not be affected by this bill. Trading in agricultural commodities and financial commodities (excluded commodities) like interest rates, currencies and equities would be affected. Not sure that was intent.

(c) SPDC determination in farm bill was not developed with foreign or global markets in mind. Not sure how well SPDC determination can be adapted to this context. Also SPDC is not self-executing; it requires an affirmative CFTC determination. Why would Congress want to make it illegal to trade a contract that businesses are relying on for significant price discovery.

7. S. 3122 (Cantwell)—Makes into a DCM any trading facility that (a) "operates one or more trading terminals" in U.S.; (b) trades contracts that serve a price discovery function for a commodity delivered in the U.S.; and (c) is regulated by a foreign regulatory agency. Terminates existing exemptions from DCM registration.

(a) FBOTs today operate under a CFTC-approved no-action process, not Section 4(c) exemptions.

(b) FBOTs do not need to operate "trading terminals" in the U.S. Web access is world-wide. Also servers that facilitate the pace of execution of U.S. customer orders on FBOTs are not considered to be trading terminals. Servers are not trading terminals.

(c) Price discovery function is an undefined, new term. To the extent it is different than the "significant price discovery contract" definition from the 2008 Farm Bill, it is not clear why a new phrase is needed. To the extent it is the same as the farm bill formulation, it is not self-executing, adds administrative cost to CFTC regulation, and may not be applicable to energy markets traded overseas. Also has the perverse consequence of penalizing a foreign exchange for developing an energy contract (Brent) which a U.S. exchange later copies.

The CHAIRMAN. Thank you very much.

Mr. Peniket.

## STATEMENT OF DAVID J. PENIKET, PRESIDENT AND COO, ICE FUTURES EUROPE, LONDON, UNITED KINGDOM

Mr. PENIKET. Chairman Peterson, Members of the Committee, it is a privilege to appear before you today in respect to the issue of regulation of foreign boards of trade.

I am David Peniket, President and Chief Operating Officer of ICE Futures Europe. ICE Futures Europe is the largest regulated futures exchange for energy trading in Europe and the second largest in the world. We trade a number of energy contracts which are used as pricing benchmarks both in Europe and internationally. Our Brent crude futures contract is the leading benchmark for the oil traded outside the United States. Our gasoil futures contract is the main European middle distillate benchmark.

Since February of 2006, we have offered financially settled WTI crude oil futures, giving our customers the ability to trade the main U.S. and European crude oil futures on a single platform.

In conjunction with our partners at the Chicago Climate Exchange, we operate the market for the European Climate Exchange, which is the largest carbon market in the world.

ICE Futures Europe was founded as the International Petroleum Exchange in 1980. It was acquired by IntercontinentalExchange in 2001 and was subsequently renamed. But ICE Futures Europe remains a U.K.-recognized investment exchange subject to the regulation of the U.K. Financial Services Authority. ICE Futures Europe is a U.K. company with its own board, on which I sit, and which is chaired by Bob Reid, former Chairman Shell U.K.

The contracts we trade are subject to U.K. law and the jurisdiction of the English courts. All the contracts are cleared through a

U.K. clearinghouse, currently LCH.Clearnet, shortly to be ICE Clear Europe.

Our headquarters are an international house near Tower Bridge, where a team of nearly 70 exchange staff are based. All our regulation compliance and market supervision staff are based in London.

Since 1999, we, in common with many other exchanges, have operated screens in the United States under a No Action letter from the CFTC. This is the regime that all international derivatives exchanges use to achieve access to the U.S. market. The regime has been highly successful in helping to promote the growth of derivative markets around the world. A framework of mutual cooperation between derivatives regulates this. This meant that markets have grown strongly and without the disruption that has been present in other parts of the financial services industry.

Since we launched our WTI contract, the CFTC has been concerned to understand its implications of the WTI market as a whole. We collect large trader reports to the contract on a daily basis, and this information has been shared regularly with the CFTC, at first informally and then subject to a Memorandum of Understanding between the CFTC and the FSA. That Memorandum of Understanding was strengthened 2 months ago when we agreed to provide additional large trader information to the CFTC and to alert them when certain position accountability levels were exceeded.

On the 17th of June, 2008, the CFTC amended the No Action letter under which we operate. This amendment further formalized the information-sharing arrangements and required that we impose position limits and position accountability levels in respect of WTI. We will comply in full with the terms of this letter subject to the approval of the U.K. Financial Services Authority.

In the normal course of our operations, we receive information requests from the CFTC via the FSA from time to time. We have always cooperated with such requests. In our view, the CFTC now has all the information it needs to fulfill its role as overseer of the WTI futures markets. We will continue to operate closely with them.

Mr. Chairman, it is in our interest and the interest of our market participants to ensure that the energy markets are fair, orderly and free of manipulation. The only way in today's global, interconnected world that we will we be able to ensure this is through active cooperation between regulators and exchanges around the world. We respectfully submit that the effective regulation of today's global commodity markets is best served by measures that promote and enhance such regulatory cooperation.

Thank you for your time, Mr. Chairman. I would be happy to take any questions.

[The prepared statement of Mr. Peniket follows:]

PREPARED STATEMENT OF DAVID J. PENIKET, PRESIDENT AND COO, ICE FUTURES EUROPE, LONDON, UNITED KINGDOM

Chairman Peterson, Ranking Member Etheridge. I am David Peniket, President and Chief Operating Officer of ICE Futures Europe.

I very much appreciate the opportunity to appear before your hearing today to share ICE Futures Europe's views on foreign boards of trade. The United States'

approach to the regulation of foreign boards of trade is an important issue for the global trading community.

**Executive Summary**

1. ICE Futures Europe is a 27 year old London-based fully regulated futures exchange. ICE Futures Europe is one of the largest European energy markets. It offers a "cash-settled" WTI crude oil contract, meaning positions in the contract do not result in taking physical barrels of oil off of the market or permit a price squeeze.

2. 85% of the open positions for the WTI crude futures and options market are held on the NYMEX, which establishes the price of WTI crude oil due to the physical nature of the NYMEX market. ICE Futures Europe prices its contract, which has a 15% market share, based on the settlement price discovered in the NYMEX WTI market.

3. ICE Futures Europe, as a fully regulated exchange, monitors positions daily and has enforcement powers as does the FSA to detect and punish attempts a manipulation.

4. Pursuant to amended CFTC and FSA agreements in May and June of 2008, the ICE WTI contract will be subject to the same U.S. regulatory provisions as the NYMEX WTI contract, including position reporting and position accountability and limits

5. Finally, ICE Futures Europe margin rates have tripled from May 2007, while prices have approximately doubled. The use of margining as a tool for controlling price movements or market participation, which is one of the proposed market alterations, could have extremely negative consequences for market participants and consumers and could result in excessive volatility, the hoarding of oil or the departure of regulated markets from the U.S.

**Background**

ICE Futures Europe (the "Exchange"), formerly the International Petroleum Exchange of London Ltd, is the leading regulated energy futures exchange outside the United States of America. The Exchange was formed in 1980 and operated as a mutual exchange until 2001 when it was acquired by IntercontinentalExchange, Inc. The Exchange's primary mode of operation was open outcry trading until 2005, when we converted our markets to fully electronic trading. ICE Futures Europe is the home of the Brent Crude Futures contract, a North Sea blend of crude oil. The Brent complex, of which our futures contract is a part, forms the basis for pricing—directly or indirectly—⅔ of world traded crude oil.[1] We also offer a Gas Oil futures contract which serves as the primary pricing benchmark for European middle distillate products, as well as UK natural gas and electricity contracts. In conjunction with our partners at the Climate Exchange we operate the futures market for the European Climate Exchange, which is now the largest carbon futures market in the world.

The customers of ICE Futures Europe's market, like those of most major exchanges, are based around the world. Even when ICE Futures Europe was an open outcry exchange, customers from around the world used its markets by phoning their orders in to the trading floor in London. Today the trading floor is a virtual one, with orders being sent to the market through computer terminals—but the global nature of our markets has not changed. We have regulatory clearance for our screens to operate in over fifty jurisdictions globally.

Responding to customer demand, in February 2006, ICE Futures Europe launched a cash settled futures contract for West Texas Intermediate (WTI) crude oil to complement our Brent crude oil contract since both are similar "light sweet" grades of crude oil. We chose to offer a financially settled WTI contract at a time when NYMEX was committed to retaining and promoting open outcry trading rather than pursuing electronic trading despite market demand. As the first exchange to launch a fully electronically-traded WTI contract on an around-the-clock trading platform, our contract was successful in taking market share from NYMEX. Since the subsequent launch of electronic trading by NYMEX in September 2006, NYMEX's WTI contract has grown more rapidly than the ICE market. **Today, ICE has a relatively small 15% share of total WTI futures and options open interest, while NYMEX retains the remaining 85%.** Nevertheless, the ICE WTI contract is an important contract for ICE Futures Europe, as it is used by commercial participants to hedge exposure to small differences in WTI and Brent prices. Notably,

[1] Source: *Brent: A User's guide to the Future of the World Price Marker* (Liz Bossley, CEAG, 2007).

NYMEX similarly offers a cash-settled Brent crude oil futures contract that settles on ICE Futures Europe's final settlement price for precisely the same reason.

*Regulatory Framework: ICE Futures Europe's Operations*

ICE Futures Europe is a Recognized Investment Exchange which operates under a legislative framework set out in the Financial Services and Markets Act 2000. This framework gives the exchange an equivalent regulatory status under UK law to the status that U.S. Exchanges have under U.S. law. The Exchange is subject to supervision by the Financial Services Authority, which has a designated team whose responsibility is to oversee the work of UK exchanges and other recognized bodies. The financial services regulatory regime in the United Kingdom is well-established and has been used as a model in the design of other regulatory systems around the world.

ICE Futures Europe is a UK corporate entity that files that is registered with Companies House, whose principal place of business is in the UK and which is subject to UK law. All contracts traded on ICE Futures Europe are subject to UK law and regulation. For European market participants, this is important for a variety of reasons, including the applicability of UK bankruptcy and insolvency laws in the event of a contract default. All of ICE Futures Europe's contracts are cleared in London by LCH.Clearnet Limited, which acts as central counterparty to all trades on the Exchange. Clearing of such contracts will shortly be transferred to our own new London-based clearing house, ICE Clear Europe.

At all times since it became a subsidiary of ICE, Inc., ICE Futures Europe has been headquartered in London and has operated as a Recognised Investment Exchange. At all times during this period, ICE Futures Europe has been governed by a separate board of directors which is accountable to the Financial Services Authority for the operation of ICE Futures Europe's markets. The board is chaired by Sir Bob Reid, a former Chairman of Shell UK, and also includes three independent European-based board members: Lord Fraser of Carmyllie, Robert Mabro and Peter Nicholls. Jeff Sprecher, Chairman and Chief Executive Officer of IntercontinentalExchange and Scott Hill, ICE Chief Financial Officer are also members of the Board. A Subcommittee of the Board, the Risk Committee, made up of the independent directors, meets separately to consider financial and operational risk issues, including financial resources. This separate governance structure and degree of independence within the ICE, Inc. group is mandated by the Financial Services Authority in order for ICE Futures Europe to maintain its status as a Recognised Investment Exchange and a self regulatory organization. ICE Futures Europe has approximately seventy full-time employees, all of whom are based in the United Kingdom.

*Our Role*

Our role as a Recognised Investment Exchange is to provide a fair and orderly market in which the interaction of market participants is allowed to determine prices. We strive to be strictly neutral and independent. Our role is neither to be on the side of the producer nor the consumer; we are dedicated to ensuring that price formation is fair.

*A Fair and Orderly Market*

Being a fair and orderly market means operating within a framework laid down by law and regulation. The ultimate decision-making body of the Exchange is its board of directors. The rule-making functions are fulfilled by the Authorization, Rules and Conduct Committee under delegation from the board. Changes of significance are brought back to the board for approval. There is an independent disciplinary framework which is followed in circumstances where the Exchange pursues disciplinary action against members.

The ICE electronic trading platform has sophisticated audit facilities which allow it to record extensive information about every trade on the platform. Compliance staff monitors trading patterns and price movements to identify circumstances which warrant further investigation. They seek to identify improper conduct, and in particular, any attempt to manipulate the market.

As well as receiving information about transactions, the Exchange also receives information about any large positions held by members, including details of the customer(s) responsible for such positions. While ICE Futures does not presently impose formal position limits (but recently has agreed to do so with respect to its WTI contract at the request of the CFTC), the Exchange receives daily reports from all members who hold large positions in the front 2 months of any contract detailing who is responsible for holding such positions. The Exchange has the regulatory authority to require that members reduce positions in any contract if they judge them to be unduly large, and has the power to compulsorily close out positions.

There is a particular focus on physically-delivered contracts—in particular the Gas Oil contract—where it is possible for delivery squeezes to occur, for example by a single participant obtaining control of most of the oil due for delivery in a particular month. In financially-settled contracts such as WTI this risk of a squeeze or a "corner" does not exist in the same way because physical delivery does not occur.

The Exchange has the power to bring disciplinary proceedings against its members. Where an investigation identifies issues beyond its direct control, the Exchange will notify the Financial Services Authority and, if appropriate, relevant overseas regulators such as the CFTC.

*Cooperation With the CFTC*

As noted above, the ICE WTI contract is financially-settled, which narrows the area of risk in comparison with a physically-delivered contract. Nonetheless it is clearly important that the CFTC has the opportunity to have an overview of the market to ensure that there is no activity across NYMEX and ICE that might be construed as price manipulation or market abuse. In November 2006, ICE Futures Europe, through the Memorandum of Understanding between the FSA and the CFTC, began providing trader position data on WTI for the prompt 2 months. On 29 May 2008, we agreed with the CFTC and FSA on an extension of this information sharing to encompass position information across the entire expiry horizon, on a daily basis. Portions of this agreement have already been instituted—the CFTC already receives an analysis of positions in the WTI contract on a member by member basis for every contract month. Full implementation of the expanded information sharing agreement is due in the near term.

Furthermore, on 17 June 2008, the CFTC announced an amendment of the conditions under which the Exchange is permitted to operate through direct screen based access in the United States. In addition to formalizing the information sharing arrangements announced in May, the amended letter conditions direct screen access on ICE Futures Europe's adoption of equivalent U.S. position limits and accountability levels on the ICE WTI Crude Oil futures contract. The Exchange will follow similar U.S. hedge exemption requirements and will report violations of any position limits to the CFTC. In addition, ICE Futures Europe will provide data identifying commercial and noncommercial participants that will allow the CFTC to incorporate the ICE Futures WTI contract into the CFTC's Commitments of Traders report, its weekly report on the level of commercial and speculative activity in a given market.

The revised Commission staff foreign access conditions must be satisfied by ICE Futures Europe within 120 days. Rule changes to implement the program are subject to the approval of the UK Financial Services Authority.

*Rising Oil Prices*

Oil prices are at historically high levels. The cause of these price increases are complex and much has been written about them, particularly in recent weeks. Many commentators have asserted that the bulk of the recent increase in oil prices is related to depreciation in the value of the dollar and supply and demand fundamentals.

In a report published earlier this month, the International Energy Agency said, "*supply growth so far this year has been poor and higher prices are needed to choke off demand to balance the market.*" It went on to say that abnormally high prices are largely explained by the fundamentals.

Jeffrey Harris, the Chief Economist of the CFTC said in a recent Senate testimony that he did not see any evidence that the growth of speculation in oil has caused the price to rise. Rising prices might have stimulated the growing investment rather than the other way round, Harris noted. In the oil futures market, investment can flow in without driving up the price because the speculators are not buying actual crude to be able to hold onto it or keep it off the market. These contracts are either traded out of prior to expiration or, in the case of a financially settled contract, held to expiry with an exchange of cash flows between the buyer and seller in connection with the open contract. Trading in futures contracts allow market participants to take a view on future price direction, but the number of views being expressed through this trading does not affect the amount of oil available to be consumed in the marketplace.

Some have asserted that the primary cause of recent oil price rises is speculation. "Speculation", however, needs to be distinguished from manipulation, which is to deceive investors by controlling or artificially affecting a market. A central role of a regulated marketplace such as ours is to take steps to prevent and detect such manipulation.

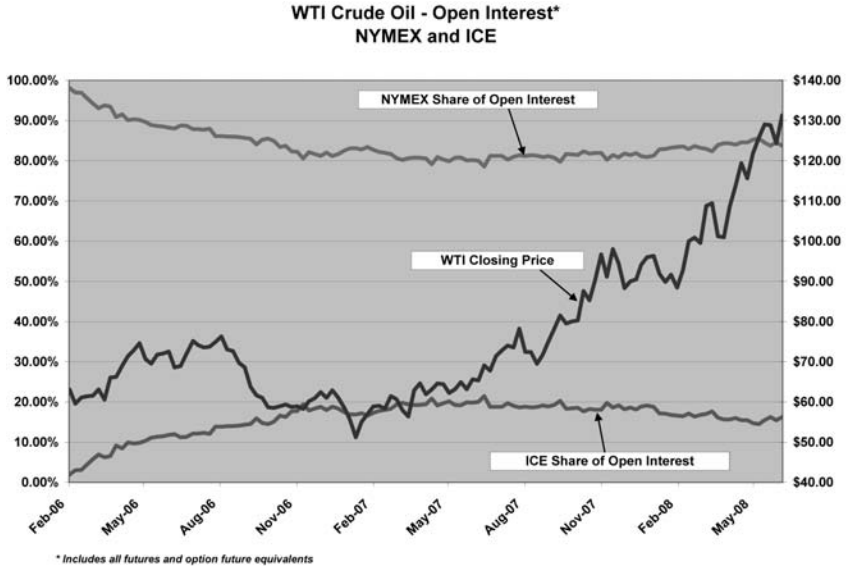
We prefer the term "financial participation" to "speculation". Such participation helps to increase liquidity, which makes it easier for market participants to get in

and out of positions at a given price, and, in fact, makes it more difficult for any individual participant to manipulate the market by creating an artificial price. Financial participants are the counterparties to the commercial entities who hedge their production or consumption. Such participants can take either 'long' or 'short' positions depending on their expectations of the way in which prices will change.

*Recent Oil Price Movements*

The increase in oil prices has been particularly marked since January 2007, when oil prices stood at $58 per barrel. During the period from 2000 to 2007 we had seen a steady upward movement in oil prices, but over the past 6 months in particular we have seen a breakout from those price levels. Importantly, during this time, the dollar has been significantly devalued, supplies have decreased, and demand has remained constant or even grown by many accounts.

Some have asserted that the change in WTI prices since the beginning of 2007 has been driven by speculative traders building large positions in the ICE WTI contract. The facts, however, indicate otherwise as *ICE Futures Europe's share of global WTI open interest has declined from about 20% to 15%* over that same period. Furthermore, the total WTI open interest, on both the Nymex and ICE contracts has not increased materially over the past year, and indeed is significantly lower than its peak levels.




We also note that the CFTC has had access to information regarding trading in the nearby delivery months for ICE WTI since the contract's launch in 2006. Furthermore, the CFTC's Director of Enforcement recently stated publicly that the CFTC has seen no evidence of manipulative activity in ICE Futures Europe's WTI markets based upon its monitoring activity.

*Margin Levels*

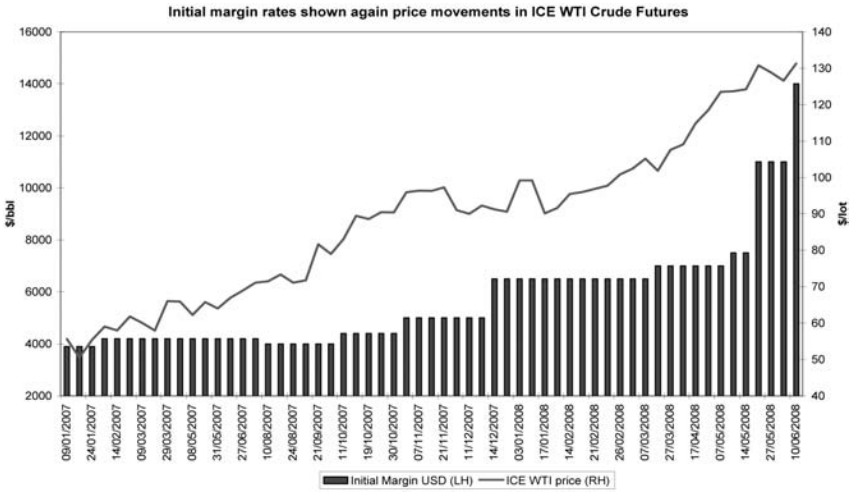
One proposal currently under consideration is to require the CFTC to substantially increase the margin requirement on crude oil futures trades. It is the responsibility of a futures market to be a neutral venue for the setting of prices. Margins are required by clearing houses for the purpose of ensuring that they have adequate security in the event of the default of a market member. Margins are used by a clearing house to manage risk and should be set on the basis of the needs of risk management and of risk management alone. The level of margin is calculated by clearing houses on the basis of calculations carried out in accordance with a proven margining methodology such as SPAN—an approach which was developed by the Chicago Mercantile Exchange and is also used by Nymex and LCH.Clearnet and will be used by ICE Clear Europe. Changes in margin levels tend to be driven by changes in price levels and levels of volatility.

Artificially increasing margin levels on regulated futures markets would drive business either to futures markets in other jurisdictions where there are no such

constraints, or to off-exchange OTC marketplaces where clearing is not available. Moving business away from cleared markets is precisely the opposite of what should be done at a time of highly volatile prices and systemic financial risk. Clearing provides a valuable function in the mitigation of financial risk and has been a tried and tested source of risk mitigation at a difficult time for financial markets.

Even if margins were to be increased it is not clear that such increases would reduce price levels. Such steps could actually drive up prices, particularly in circumstances where commercial participants found it more difficult to meet higher margins than financial participants, or where financial participants with short positions were forced to buy them back.

Margin levels have in fact been increasing over recent months. Margin levels today are over 3.5 times margin levels at the start of 2007. They have been set at those levels because of the higher volatility that we have seen in oil markets. We have not seen evidence that this increase in margins has reduced prices.




**Foreign Boards of Trade**

In 2006, the CFTC convened public hearings to consider the issue of the regulation of foreign boards of trade in the U.S. Consideration of the issue at that time was largely triggered by the launch of the ICE WTI Crude futures contract. An overwhelming majority of participants in those hearings thought that the CFTC 'no action' regime had been very successful. The CFTC reaffirmed its no action regime thereafter,[2] recognizing the benefits of regulatory cooperation and mutual recognition.

The basis of this approach is that markets, particularly oil markets, are global. Participants are based all over the world and cooperation between regulators is crucial in this context. The concept that each exchange be subject to the jurisdiction of one primary regulator has avoided duplication and conflicting regulations that would have made it unduly burdensome and expensive for participants to conduct their trading activities within the current arrangements. Other regulators with an interest in the activities of the exchange can exercise secondary oversight and jurisdiction through consents to jurisdiction, and through information sharing with the correspondent regulator.

ICE Futures Europe has cooperated fully with the CFTC and will continue to do so. As well as supplying position information on a regular basis ICE has provided extensive transaction information to CFTC to assist in investigations. We share the CFTC's desire to see that markets are fair, orderly and free of manipulation.

**Conclusion**

We recognize the severe impact of high crude oil prices on the U.S. economy and understand the Congressional desire to "leave no stone unturned." However, with a 15% share of global WTI futures and options open interest; we feel it is highly

[2] CFTC Release: 5252–06 issued October 31, 2006.

unlikely that our WTI contract is the primary driver of WTI prices. This "inconvenient truth" clearly contradicts any notion of a "London loophole".

Our view, Mr Chairman, is therefore that the current regulatory regime works well, and that greater regulation is not the answer. The priority for regulators in our increasingly interconnected world should be increasing cooperation with their counterparts in other countries. This is best promoted and developed by the establishment of international best practices in the context of a framework of regulatory mutual recognition. This is a framework in which the CFTC and the FSA take a leading role, and one which they should seek further to build upon in the future.

The CHAIRMAN. Thank you.

Now Mr. Ramm.

**STATEMENT OF GERRY RAMM, SENIOR EXECUTIVE, INLAND OIL COMPANY, EPHRATA, WA; ON BEHALF OF PETROLEUM MARKETERS ASSOCIATION OF AMERICA; NEW ENGLAND FUEL INSTITUTE**

Mr. RAMM. Mr. Chairman and Members of the Committee, I appreciate the opportunity to provide some insight on this extreme energy crisis that could well cost human lives this winter. I am an officer with Petroleum Marketers Association of America. I represent real businesses delivering gas and diesel to real people.

PMA has communicated for the past 3 years on the urgency and has specifically testified before Congress seven times on the grave need to address this issue. Before I address the foreign boards of trade issue, PMA recommends that Congress acts immediately to end excessive speculation in the energy commodities market, and if strong legislative action cannot be executed now, that the CFTC needs to exercise its emergency authority. Specifically CFTC must respond and suspend speculative long positions for noncommercial traders until this market returns to functional behavior.

Just yesterday the price of heating oil on the futures market went up 16¢. In my home State of Washington, diesel moved up as much as 17¢ a gallon, with no supply disruption and no event that should have caused that pricing.

Excessive speculation on the energy trading facilities is the fuel that is driving the runaway train in crude oil prices, which has dragged every petroleum refined product up with it.

Recently several Big Oil executives testified before Congress that oil should be about half the price that it is today. Our marketers are facing a crisis due to the dramatic run-up of gasoline, diesel and heating oil, and have lost faith in the ability to hedge for the benefit of our customers. For that reason, PMA has implemented a Stop Oil Speculators Campaign which will be showing up at all the gas stations and convenience stores throughout this nation.

First and foremost, there must be full market transparency. Over the last 8 years, energy commodities have been exempt from Federal oversight due to a series of legal and administrative loopholes. This has led to excessive speculation being driven on exchanges that are not fully transparent and accountable to U.S. rules of law.

Certain boards of trade that are operating here in the United States are virtually exempts from CFTC regulation. Because these are unregulated trades, there is no record. These trades, if they were manipulative in nature, it would increase the cost of the American consumer, and it would increase the cost of the commodities sold. Such trading would leave no public data, and there

would be no fingerprints. Why would the CFTC not want to exercise its authority over the trading platforms that are operating within the United States and trading U.S.-delivered commodities?

In response to the comment the traders will simply move overseas, 20 percent of the world consumption takes place here in the U.S., and foreign boards of trade need access to U.S. markets, as evidenced by the fact that they have sought No Action letters issued by the CFTC.

PMA supports efforts to increase domestic supply. They support alternative fuels and conservation that will help ease prices in the long term; however, time is running out. Our businesses are at risk, and our consumers are hurting. Congress and the President must rein in excessive speculation which is driving gasoline and heating oil prices to the levels that aren't justified by simple fundamentals of supply and demand.

Again, until Congress can get a handle on the commodity markets, the Petroleum Marketers Association of America recommends that Congress acts immediately to end excessive speculation in the energy commodity markets. And if strong legislative action cannot be executed now, specifically CFTC should—must suspend speculative long positions for noncommercial traders until the markets return to functional behavior.

If Congress does not take immediate action to close all the loopholes and apply aggregate position limits on controlled entities set by commercial hedgers and imposed by the CFTC, some people will not be able to heat their homes this winter and may freeze to death. Some people will lose their jobs because they can't afford to drive to their jobs. And Congress will not be able to say that they were not warned of this impending problem.

PMA strongly supports the free exchange of commodities on an open, fair, regulated, transparent market. PMA also supports consumers' need to fuel their cars, to buy food and heat their homes. Reliable futures markets are crucial to the entire petroleum industry and to consumers. Let's make sure that these markets are competitively driven by supply and demand.

We want to thank you for the opportunity to speak to you today, and I would answer any questions that you may have.

[The prepared statement of Mr. Ramm follows:]

PREPARED STATEMENT OF GERRY RAMM, SENIOR EXECUTIVE, INLAND OIL COMPANY, EPHRATA, WA; ON BEHALF OF PETROLEUM MARKETERS ASSOCIATION OF AMERICA; NEW ENGLAND FUEL INSTITUTE

Honorable Chairman Peterson and Ranking Member Goodlatte 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 state 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. Today we operate seven gas stations and convenience stores and we also supply fuel to eight 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.

**The Competitiveness of the Retail Motor Fuel and Heating Fuels Industry**

The state of the petroleum marketing and the retail gasoline industries are in their most critical environment ever. 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 retail motor fuels industry is one of the most competitive industries in the marketplace, which is dominated by small, independent businesses. Retail station owners offer the lowest price for motor fuels to remain competitive, so that they generate enough customer traffic inside the store where station owners can make a modest profit by offering beverage and snack items. For instance, even as gasoline wholesale prices rise with each jump in crude oil prices, station operators are reluctant to be first on their corner to go up a penny because every station's prices are posted on huge signs. To highlight the competitiveness of the retail gasoline station industry, one does not need to look any further than to the recent ExxonMobil Corp. announcement which said that it plans to sell its remaining company-owned gas stations due to falling profit margins and significant competitive growth in the industry.

Because petroleum marketers and station owners must pay for the inventory they sell, their lines of credit are approaching their limit due to the high costs of gasoline, heating oil and diesel. Due to high gas prices, marketers are having a hard time paying invoices before the due date which causes a significant strain on cash flow. Furthermore, credit card interchange fees are now the second biggest expense item on a marketers' profit margin which collect anywhere from 8¢ to 10¢ per gallon. Couple all of this with banks who are less amenable to lend money, marketers are now wondering how they are going to stay in business. I have heard from marketers' across the country that the dealers they supply are having to borrow against equity in their business to keep operating. If gas prices continue to rise, these dealers may eventually go out of business.

Below is from a petroleum marketer that shared his story on how high gas prices are affecting his business.

> *"Our jobbership (petroleum marketer business) has been around since 1926. A couple of years ago we had about 25 dealers and were running 11 convenience stores. The high prices caused our carrying costs and financial requirements for accounts receivable and inventory to go up dramatically. The high cost has also caused our credit card fees to soar. Suppliers are unwilling to up credit lines with the instability in the industry. I have had to sell four of my convenience stores just to try and stay afloat. I am attempting to sell three more and will let the lease run out on two more. I have cut my staff to the bones. Three of my dealers have closed operations and I don't expect them to be the last."*

From a petroleum marketer in Arkansas:

> *"If we didn't have a Line of Credit at the bank we would be out of business. The Line of Credit costs my company approximately $8,000 per month. This also limits the growth of our company because we don't have the capital for new projects. Another problem is that our smaller 'Mom & Pop' country convenience stores simply don't have the money to operate under these conditions. They have charge accounts and when their customer pays them late then our payment is delayed as well. Smaller farm deliveries are also taking a toll on our industry. The farmers and ranchers can't afford the high diesel prices so instead of filling their 500 gallon tank they only order 200 gallons."*

Stories like these above are very common right now. Something must be done to curb energy costs. PMAA, along with several other trade associations, have come to the conclusion that excessive speculation is behind the recent run-up in prices.

**Excessive Speculation Is Driving Energy Costs**

Excessive speculation on energy trading facilities is the fuel that is driving this runaway train in crude oil prices. The rise in crude oil prices in recent weeks, which reached $145.85 on July 3, 2008, has dragged with it every single refined petroleum product. According to the Department of Energy, the cost of crude accounts for roughly 75 percent of the pump price, up from 62 percent in January of 2008.[1] Wholesale heating oil prices from March 5, 2008–July 1, 2008 have risen from $2.97 to $3.92.[2] The spike comes despite it being summer in the Northeast. The data doesn't add up.

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[1] Energy Information Administration, "Gasoline and Diesel Fuel Update," May 2008.

[2] Energy Information Administration, "U.S. No. 2 Heating Oil Wholesale/Resale Prices," March 5–July 1, 2008.

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 oil from $50 to approximately $70 per barrel." Who would have thought that crude oil futures would rise to over $145 a barrel?

Commodity futures exchanges were predominately created for oil producers and consumers to offset price risk by entering into a futures contract for future delivery. Over the years, PMAA members have noticed a disconnect between commodity prices and supply and demand fundamentals. For instance, Colonial Pipeline had 150,000 barrels of surplus heating oil available for auction on May 7. On that same day heating oil futures on the NYMEX settled at another record-high with its June contract closed with a 9.3ct gain at $3.38/gal with New England temperatures averaging in the high 70s. PMAA has lost faith in the ability to hedge for the benefit of their customers.

**There Must Be Full Market Transparency and Accountability**

U.S. destined crude oil contracts could be trading DAILY at a rate that is multiple times the rate of annual consumption, and U.S. destined heating oil contracts could be trading daily multiple times the rate of annual consumption. Imagine the impact on the housing market if every single house was bought and sold multiple 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 noncommercial speculative investment in crude oil, natural gas and other energy products. Much of the noncommercial (*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.

PMAA would like to thank Congress for passing the farm bill (H.R. 2419), specifically, Title XIII, which will bring some transparency to over-the-counter markets. However, the farm bill is only a first step.

**Closing the Administrative Foreign Board of Trade Loophole**

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 IntercontinentalExchange (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." Currently, FSA doesn't monitor daily trading to prevent manipulation, publish daily trading information, or impose and enforce position limits that prevent excessive speculation.

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. According to the Securities and Exchange Commission filings, traders on ICE made bets on oil with a total paper value of $8 trillion in 2007, up from $1.7 trillion in 2005.[3] 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."

While PMAA applauds the recent CFTC announcement that it will expand information sharing with the U.K.'s Financial Services Authority and ICE Futures Europe to obtain large trader positions in the West Texas Intermediate crude oil contract, more needs to be done to prevent and deter market excessive speculation and manipulation on all foreign boards of trade.

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[3] Herbst, Moira; *Speculation—but Not Manipulation: Financial News,* BUSINESS WEEK, May 30, 2008.

PMAA urges Congress to close the administrative Foreign Boards of Trade Loophole via review or elimination of CFTC "No Action letters" to overseas energy trading platforms. PMAA supports any legislative remedy that would ensure that all offshore exchanges 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.

**Institutional Investor Influence on Energy Commodity Prices**

I also would like to discuss the influence institutional investors have on commodity markets. Last month, Michael Masters, Managing Member and Portfolio Manager of Masters Capital Management, LLC, a hedge fund, argued before the Senate Committee on Homeland Security and Government Affairs that institutional investors are the cause of the recent run-up in commodity prices. Institutional investors are buying all the commodity contracts (going long), especially energy commodities, and are not selling, thereby causing the demand for contracts to increase and putting further pressure on commodity prices.

The institutional investment "buy and hold" strategy has further inflated crude oil price because index speculators do not trade based on the underlying supply and demand fundamentals of the individual physical commodities. When institutional investors buy an initial futures contract, that demand drives up the price. This has the same effect as the additional demand for contracts for delivery of a physical barrel today which drives up the price for oil on the spot market. Thus, this "buy and hold" strategy distorts the futures markets price discovery function.

Institutional investors are not traditional speculators who profit when prices go up or down. Institutional investor's "buy and hold" strategy only profit when prices continue to rise which can have serious consequences. Because the speculation bubble might soon burst, pension funds and endowment funds will likely suffer the greatest losses because they are notoriously slow to react to quickly changing market conditions. When the market corrects, hedge funds will quickly reduce holdings and cut their losses.

Masters also stated that since commodities futures markets are much smaller than equity markets, billions invested into commodity markets will have a far greater impact on commodity prices than billions of dollars invested in equity markets. Masters testified that while some economists point to China's demand for crude oil as the cause for the recent rise in energy costs, he disclaims that assumption. In fact, Masters' testimony highlights a Department of Energy report that annual Chinese demand for petroleum has increased over the last 5 years by 920 million barrels. Yet, over the same 5 year period, index speculators' demand for petroleum futures has increased by 848 million barrels, thus the increase in demand from institutional investors is almost equal to the increase in demand from China! Wouldn't this demand by institutional investors have some effect on prices?

**The Weak Dollar Can Not Explain the Recent Run-Up in Energy Costs**

Also, many economists and financial analysts report that the weak dollar has put pressure on crude oil prices. While the weak dollar explanation is partly true because crude oil is denominated in dollars which reduces the price of oil exports for producers, leading them to seek higher prices to make up for the loss, this does not justify crude oil's move beyond $145 a barrel. On May 1, 2008, the front month NYMEX WTI crude oil contract closed just under $113 per barrel. Three weeks later the same front month NYMEX WTI contract was trading at over $132 per barrel. In that same period of time the dollar traded between $1.50 to $1.60 against the Euro. While the Euro strengthened against the dollar, it doesn't justify that crude oil should have increased $19. There were no significant supply disruptions during this time period.

While the depreciation of the dollar and geopolitical risk have put pressure on energy prices, PMAA believes these factors do not justify the drastic run-up in crude oil prices over the last few months. Congress and the Administration have a responsibility to ensure that commodity futures exchanges are fully transparent and accountable to the rules of law.

**PMAA urges both Congress and the President to consider the following:**

1. Closing the Administrative Foreign Boards of Trade Loophole via review or elimination of CFTC "No Action letters" to overseas energy trading platforms. PMAA supports any legislative remedy that would ensure that all off-shore exchanges 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.

2. Raising margin requirements (or necessary collateral) for noncommercial 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 U.S.C. § 1a(11). Currently, margin requirements in futures trading are as low as three percent for some contracts. To buy U.S. equities, margin requirements are a minimum of 50 percent.

3. Requiring noncommercial 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) has introduced legislation H.R. 6264 that would require anyone trading oil to have the capacity to take physical delivery of the product).

4. 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 U.S.C. § 1a(11).

5. Significantly increase funding for the CFTC. The FY 2009 President's budget recommendation is for $130 million. While this is an increase from previous years, CFTC staff has declined by 12 percent since the commission was established 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 on the CFTC, to take a stand against excessive speculation 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.

The CHAIRMAN. Thank you very much.

Mr. Greenberger, welcome again.

**STATEMENT OF MICHAEL GREENBERGER, J.D., PROFESSOR, UNIVERSITY OF MARYLAND SCHOOL OF LAW, BALTIMORE, MD**

Mr. GREENBERGER. Thank you, Mr. Chairman and Members of the Committee.

One of the nice things about this hearing is I have run into people I haven't seen in well over a decade, including Mr. Young, with whom I had many happy experiences when I was at the CFTC. I am a little intimidated by the fact that he teaches a derivatives course at Georgetown because I don't know whether you realize this, Mr. Young, but I am trying to encourage the Chairman to attend one at the University of Maryland. I have even offered to run the course in Washington to make it easy for him to attend.

Mr. YOUNG. I think the Chairman could be a guest lecturer in either of our courses.

Mr. GREENBERGER. Well, another option is for him to take my position at the University of Maryland, and I would gladly chair the Agriculture Committee.

It is a pleasure to be back here today to discuss this issue. The one thing I do want to say with regard to Mr. Young's references about excessive speculation is I believe that excessive speculation is still very much a part of this statute. As the Chairman knows, I have had my little problems with the Permanent Subcommittee

on Investigations on the Senate side. At one time when we were all happily working together, they issued a report in June of 2007, and I would reference pages 44 to 45 where they did an investigation of the Amaranth collapse, and they outlined the important role that excessive speculation plays in the Commodity Futures Modernization Act.

The other thing I would like to say is that I was the evil genius who wrote the template for the No Action letters that allowed foreign board trades to come into the country. And I did so—it was a very controversial position. The Commissioners could not reach a conclusion about how to—we had a proposed rule, and they couldn't do a final rule. It was decided to defer to the staff, and there were many issues. Germany had gotten in before anybody had thought about it, and they became the biggest exchange in the world by virtue of having trading terminals in the United States. You can well imagine that every other major foreign exchange lined up at my door saying, that is not fair. They are in, we want to be in.

The Commission realized this is an important issue. We should have standards, *et cetera, et cetera.* They couldn't agree on a rule. So I wrote a template for a No Action letter with their permission, and that we began to allow exchanges in, like the International Petroleum Exchange, which the IntercontinentalExchange purchased and now stands in their place.

Those No Action letters were clearly contemplated to be for truly foreign exchanges that were in foreign countries selling foreign commodities. The fact of the matter is if we allowed them to sell something like the WTI contract, that No Action letter would never have been issued. The United States exchanges would not have allowed that kind of competition without the same kind of regulation. In fact, in June of 2006, when the IntercontinentalExchange listed the WTI contract, Dr. Newsome, was very upset about that. And for a year and a half he urged the Commission to have—I remember correctly most recently his testimony on June 2007 before this very same joint Committee, he wanted to have a level playing field. And he, if I remember his testimony correctly, because it certainly is acted out in the very effective ways that he has run NYMEX, he said, if I can't beat them, I will join them. For example, he now has an application in to have a London NYMEX. And he has said in his testimony that he will now apply for a No Action letter to have London NYMEX come to the United States and operate the same way the IntercontinentalExchange does.

Now, Dr. Newsome has said to me he is not sure what contracts he is going to list, and they haven't announced that. It just shows the evil ways within which this system works, that a U.S. exchange would go to London and come back through a No Action letter. Of course, you have the Dubai Mercantile Exchange having done the same thing, and they have announced they are going to list the WTI contracts.

In closing, I will say the CFTC, by virtue of its June 17th letter and its letter to the Dubai Mercantile Exchange a few days ago, has tightened up considerably the conditions it is imposing on the ICE, on Dubai and presumably on NYMEX when it comes back as NYMEX London. I applaud that. I think a lot of what they have

done is consistent with Mr. Etheridge's bill, which now as I read it would codify what the CFTC has done.

My personal view is that when you have trading terminals in the United States, trading 30 percent—there are arguments over what, but a lot of the WTI contract—that that operation should be regulated by the United States Government. If it causes duplicative regulation, ICE has been very clever in setting up subsidiaries. They could set up another subsidiary in the United States that would be for selling WTI, which would be regulated by the CFTC.

I think when you have a system that allows this kind of running to London and coming back here—ICE, as you know, is run in Atlanta, and the ICE Futures Europe is a wholly owned subsidiary—I really even think that is irrelevant. The question, I would say, when you have people like Mr. Ramm here hanging on by their fingernails, it doesn't look good to have the U.S. trading terminals in the United States, trading our WTI product, but being regulated by the United Kingdom. It doesn't allow real-time emergency authority for the CFTC. It does not allow for the kind of self-surveillance that we insist on by our exchanges.

My final point would be Dr. Newsome spent $6½ million on self-surveillance and has 40 employees. I am told by many, and maybe I can stand corrected, that ICE has ten people surveilling their crude oil thing. And they trade Brent, so they trade more than that. That is about 47.8 percent of world's crude oil product, as I understand it, ten surveillance people. I think if we keep the template we are now operating under, we lose a lot, but I do say that the CFTC has made dramatic strides in this regard. Thank you.

[The prepared statement for July 10 and 11 of Mr. Greenberger is located on page 100.]

The CHAIRMAN. Thank you very much, and we thank all of the panel for that outstanding testimony.

I am going to yield now to the Chairman of the General Farm Commodities and Risk Management Subcommittee, who has done a lot of work on this, Mr. Etheridge from North Carolina. And I am going to unfortunately keep you to 5 minutes.

Mr. ETHERIDGE. I will stick to it, Mr. Chairman.

Let me thank each of you for being here. I will be quick, and I will ask that you be very succinct in your answers if we can.

Let me get something on the record, if I may. On Wednesday we had testimony from some Members who were here stating, "We know the Enron loophole for the London market, 64 percent of the WTI of West Texas Intermediate crude has been traded on that market."

Now, has ICE Futures Europe ever controlled 64 percent of the world's market share of WTI contracts?

Mr. PENIKET. We have never had a 64 percent market share.

Mr. ETHERIDGE. If not, what is the highest market share that ICE has achieved in that market?

Mr. PENIKET. Our market share grew from the launch of the contract in February 2006. I can't remember precisely how high it was. Last year it was about 30 percent in terms of futures. Our share now in terms of the open interest on a like-for-like basis, including futures and options of futures equivalent, is 15 percent, and the market share at the moment is running at about 25——

Mr. ETHERIDGE. But it is growing?

Mr. PENIKET. The market share has declined over the last 3 months because NYMEX has been growing slightly faster than we have.

Mr. ETHERIDGE. Thank you.

Mr. Ramm, your testimony included several legislative recommendations. We thank you for that. Many of them weren't the topic that we are covering today, but I did notice that you did not advocate elimination of energy over-the-counter derivatives as Professor Greenberger had talked about or as has shown up in a couple of the other pieces of legislation. Do your remember if you used the swap transactions to hedge risk, or did you use them previously? And does PMA support their elimination?

Mr. RAMM. We do have members that do hedge in the futures markets. Whether or not they use the swaps or derivatives, they usually do that directly through a broker.

Mr. ETHERIDGE. So you do not recommend elimination of those?

Mr. RAMM. No. What we would recommend is position limits that are controlled and set by physical hedgers, though.

Mr. ETHERIDGE. Okay. Thank you, sir.

Professor Greenberger, you want ICE Futures Europe to rest with a designated contract market such as NYMEX. Does it need to be that everything traded on that exchange, which one of the bills before us has recommended does, or favor energy commodities traded on that exchange, which one of the other bills does, or just every energy commodity delivered to the United States?

Mr. GREENBERGER. First of all, I think they would be eligible to be a designated transaction execution facility. They wouldn't necessarily, because they don't have retail customers, as I understand it—they wouldn't have to be a DCM. They could have a lighter regulation.

I would be happy with bringing their U.S.-delivered or price-based on U.S.-delivered products under a DTF system. I know many of the bills want every foreign board of trade to register whether they trade U.S. or not. Mr. Lukken says there are 20 of them. I do not go that far. I would just say if you are a foreign board of trade trading U.S.-delivered products or based on U.S.-delivered products on U.S. terminals, you should have some form of registration with the CFTC.

Mr. ETHERIDGE. Through the CFTC.

Mr. GREENBERGER. Yes. And that would mean, if Mr. Lukken's figures are right, two out of 18 would have to register for those products.

Mr. ETHERIDGE. If they don't supply the proper information, then your recommendation is we talked about that terminal would be pulled.

Mr. GREENBERGER. Well, that is what Mr.—it is not Mr. Lukken, but the staff letters to both ICE and Dubai say if you don't follow our conditions, we are going to end our No Action letter and ask—and recommend enforcement to register under our laws. I mean, they are giving them the option of registering; they don't necessarily have to pull them.

Mr. ETHERIDGE. Sure.

Let me thank each of you. I will defer other questions. The one thing that we all are about here, and we want to make good policy in the end, but it came up to me very starkly several weeks ago when we had a large operation close that put 800 people out of work. These are real, live bodies. People have lost their jobs in a tough time. And it wasn't just energy, but it was a combination of energy tied to a run-up in commodity prices that were so fast that they could not adjust. And these are the kinds of things that we want to make good policy.

I think at the same time we want to make sure these markets are working the way they should work for the producer, for the consumer and for those who are looking for an opportunity to invest. I think it is a critical piece.

Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. I thank the gentleman.

The gentleman from Texas.

Mr. CONAWAY. Thank you, Mr. Chairman.

I appreciate the witnesses being here. Don't be discouraged by the lack of Members. The Agriculture Committee has two CPAs on it, and we are both here today.

Mr. Peniket, on June 23rd, there was reference in the London press in reaction to some of the bills that have been introduced, some retaliation by the London regulators and the Brits, something referred to as the "Balls clause" being implemented. If you would comment on that as well as being described as a participant in evil ways; you want to respond to your regulatory scheme or your self-regulatory scheme that you have in place? Is it accurate from the description of Mr. Greenberger?

Mr. PENIKET. If I could take the second part of the question first, we are a recognized investment exchange in the U.K. We are subject to the Financial Services and Markets Act and oversight of the FSA. We have our own compliance and market oversight arrangements.

On a like-for-like basis, in terms of comparison with NYMEX, I think we would need to do quite a detailed exercise to work out the exact equivalence in terms of numbers. In terms of oversight and market supervision staff, we have around 22 or 23. We, of course, have fewer contracts on our market than the number of contracts traded on the New York Mercantile Exchange.

I think the regulatory regime under the FSA is very similar to the regime under the CFTC. They are both principle-based regimes. They both put a lot of emphasis on the responsibility of the exchange as a regulated body. And the exchange itself takes power and responsibility as a regulator in terms of carrying out enforcement actions against its own members and oversight over its own members. And we have a series of procedures and oversight mechanisms that are followed on a regular basis to prevent market manipulation and to detect market manipulation if it occurs.

In terms of the publicity in the London press over the Balls clause, the "Balls clause" is the Investment Exchanges and Clearing Houses Act of 2006, which is a piece of legislation designed to prevent regulatory changes being—disproportionate regulatory changes being imposed on U.K. exchanges as a result of regulatory changes overseas. We will have to notify certain changes in rules

that we intend to make in order to comply with the CFTC's rules to the FSA. We do not believe that the rule changes that we are going to be notifying are disproportionate. We think they are entirely reasonable, and we don't see that that Act should come into play.

Mr. CONAWAY. The idea of regulating that activity here in the United States for terminals in the United States, if we made it so tough mechanically, can all of that trading activity be moved overseas, conducted somewhere else? Do you have to have, at the end of the day, a U.S. terminal to actually be doing what you are doing?

Mr. PENIKET. We don't have to have U.S. terminals to do what we do, but we wish to continue to have terminals in the U.S.; because the U.S. is an important part of the global crude oil market. It is not a simple question of establishing a separate subsidiary or doing something of that kind. We have open positions on the WTI contracts and our Brent contract which goes a number of years. They are traded on an U.K. exchange which has market participants around the world.

It is very important for us to be able to give market participants certainty in terms of the legal regime and the contractual regime under which they are trading. It is therefore very important for us to continue to have the same regulatory status that we have today tomorrow. And it is not simply a question of moving contracts from one legal entity to another.

Mr. CONAWAY. Mr. Greenberger, in the time that is left, can Congress go too far with this regulatory reform or change?

Mr. GREENBERGER. Yes, it can go too far. I would say it would go too far if it ordered foreign boards of trade competing with our U.S. product to come under the regulation. As Mr. Etheridge has said, there seems to be some legislation to that effect.

My own view is if a foreign board of trade is bringing terminals in the United States and competing directly with the U.S. contract markets here, there should be a level playing field, and they should be regulated the same way.

I believe the IntercontinentalExchange is headquartered in Atlanta. They have several U.S. subsidiaries, the old New York Board of Trade, they are over-the-counter markets. I recognize the problems that Mr. Peniket had said with existing contracts. I would not object to a grandfather clause or grace period that would take into account existing contracts.

Mr. CONAWAY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

The gentleman from Pennsylvania.

Mr. HOLDEN. Mr. Young, your written testimony states a concern that if Congress were to require a foreign board of trade to register as a U.S. exchange like NYMEX or CME, then U.S. firms could face liability through customers should the foreign board of trade fail to comply with the CFTC's regulations. Could you explain this in a little more detail? And would this liability exist only if we regulated FBOT, or does it exist already? And how does this risk compare with the risk U.S. firms face if the U.S. exchange fails to comply with the CFTC's regulations?

Mr. YOUNG. That covers a lot of ground. Let me try it this way. Under the proposals that you are considering, there is a theme that the foreign boards of trade will have new obligations to the CFTC. Some of those obligations you just heard discussed in the context of the No Action letters. Let us just say there is an obligation on a foreign board of trade to report daily position information, and instead of reporting that information daily, the foreign board of trade misses a day or two, or reports every other day; maybe trading is light, and that is what they do.

The way some of these proposals work, because the U.S. FCM executes or is involved in executing or confirming the execution of a trade on a foreign board of trade, whether it is for a customer in the United States or sometimes outside the United States, that FCM can be found to be liable under section 4(a) of the Commodity Exchange Act. We think it would be an unfair result, and we don't think it is an intended result, to have the FCM ensure the foreign board of trade's compliance with the CFTC's requirements. And so we would ask the Committee to work with us to make sure that there is language crafted to avoid that result.

Mr. HOLDEN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

The gentleman from Georgia.

Mr. MARSHALL. Thank you, Mr. Chairman.

We have now had hours and hours of testimony concerning the possible impact of passive law on commodities money in the futures market. It has been really quite an education for me, and my thinking has evolved substantially as a result of all of the testimony that we have received.

I find myself now thinking that it would be appropriate to suggest possible action that we might take, not that I am able to compel that by any stretch of the imagination, so that the industry generally can react and tell us whether or what effect this will have if we were to do something like that.

These markets, the markets that we regulate, the futures market, were never intended as devices to permit entities or individuals to hold commodities. They were originally designed to assist commercial hedging, and liquidity was added in the form of speculation in order to assist commercial hedging and in order to assist price discovery.

It seems to me, based on the testimony we have heard, that those who say the influx of—possibly long or short really doesn't matter, I suspect—money that is simply designed to hold commodity positions is distorting the price discovery mechanism. Frankly it may well have increased prices in all commodities, particularly energy recently, in ways that have hurt all kinds of Americans and damaged the credibility of the markets.

So if we conclude that that is the case, and we want to make sure that this money doesn't come into the market in this form, it seems to me we should do a number of different things. One, anybody doing business in the United States, whether it is over-the-counter or unregulated markets, we need to have some transparency. It doesn't have to be public. The CFTC needs to have information. We should have reporting and record maintenance for everybody. And the CFTC's experts can figure out what kind of re-

porting is needed in order for the CFTC to see the markets, not just the regulated markets, but the unregulated markets as well.

Hedging: Hedge exemptions should only be permitted to hedge commercial risk, not to lay off any other kind of risk. Laying off other kinds of risk simply distorts the price discovery mechanism and lessens the confidence that investors can have in our markets. Federal position limits should probably be established for energy markets, for energy commodities, just as they have been established in ag commodities, and probably fairly similar. We should be working with industry and experts trying to figure out what those should be in order to maximize the likelihood that we have the right kind of liquidity in the market and the right kind of speculation so that hedging, commercial hedging, and price discovery works as efficiently as possible, and there isn't distortion where price discovery is concerned.

Finally, a number of witnesses have said, "Yes, that is great, and that is exactly what you should be doing," but it won't work because people will simply go over-the-counter into what I refer to as opaque or dark markets and circumvent the position limits.

It seems to me that we might solve that problem by providing that it is a felony and violation of Federal law, punishable up to a certain amount of time in jail, plus fines, by any device or mechanism to intentionally circumvent position limits that are established on the exchanges. It seems to me that we ought to hear from industry and from those who are advocating that there is a problem here, and we need to fix this problem before more people are hurt. We need to hear from both sides whether or not an approach like that would make sense and what impact it would have.

My sense is that it would diminish, but not eliminate altogether, the avenues that various investors, pension funds and others would have in order to take positions in commodities. It would diminish that. But overall, confidence in our markets would go up. This would be a healthy move, not an unhealthy move. And it seems to me, based upon the testimony I have heard, it is something we should consider.

So we need to have feedback. And if I am way off base in these suggestions, I need to know it. And obviously my time is up. You can take this in the form of a question, requesting comments, but not comments right at the moment.

Mr. YOUNG. Mr. Marshall, would you like a quick response?

Mr. MARSHALL. No.

The CHAIRMAN. Sorry, I was in another discussion.

The gentlelady from South Dakota.

Ms. HERSETH SANDLIN. Thank you, Mr. Chairman. I don't want to yield my entire time, but I am very interested in the witnesses' comments on the very thoughtful suggestions that Mr. Marshall has put forward in light of the testimony he has heard over the last couple of days. I have at least one question I want to pose, so if you could very quickly, those of you who are interested in commenting on Mr. Marshall's statement.

Mr. GREENBERGER. Mr. Marshall, I would tell you I think in 10 minutes Senators Lieberman and Collins are introducing legislation that does much of what you say, would aggregate speculation limits across all markets. If you are a speculator, wherever you

went, if you are under U.S. jurisdiction or you are trading in the U.S., you would get a certain amount of speculation you could do, and you could apply it to any market you wanted to apply. And I was at a meeting last night on the Senate side and I think there is a lot of steam behind that, and I think that bill is very similar to much of what you said.

Mr. RAMM. Congressman Marshall, I think you are spot on on the fact the commodity markets were not designed for investors. They were designed for price discovery and risk management for commercial hedgers, commercial users. And it has completely gotten blown out of proportion. Speculators have three times the participants in those markets today. Seven years ago it was actually just the opposite. So I think you are spot on.

Mr. PENIKET. Very quickly, in terms of the CFTC seeing the market and having an overview of everything that is going on, absolutely in that the CFTC should have a view of all the trading that is going on on regulated markets and potentially beyond that that.

In terms of hedge exemptions to hedge commercial risk, I think there is a danger around that proposal and also around too severe position limits of creating circumstances where it becomes difficult for people to trade on regulated markets, and trading will move off those markets. And the devil is in the details of the construction of proposals like that. I feel that if you have too severe penalties of people circumventing position limits, that does run a danger that you will discourage people from trading in the U.S.

Mr. YOUNG. I am a lawyer, not an economist, but I will venture an opinion, that is a lay opinion, as a result of that. I am not sure I understand the evidence behind the predicate to Mr. Marshall's proposals, because what I have heard in the testimony this week is that at least on NYMEX they have testified that the so-called passive investors have been net short this year, which would have tended to drive down the price if they were moving the price. And as a result, when you see a price rise in light of that net short activity, I can't make logical sense out of pointing the finger at them and saying, that is the problem.

I also think the CME's testimony on this has made some very good points that should be taken into account, and I find that important.

Last, I know the CFTC is conducting an investigation and is looking at more data and more granularity at this point. And until they finish, I don't really want to speculate about what the role of speculators has been. I would like to see the data.

Having said that, I think every idea should be considered, because I know that these are serious times, and I am a little concerned about one aspect of the proposal, and that is does this make it harder for hedgers who are looking at a time horizon of a year or 2 years out to hedge their positions if you remove some of the liquidity from the market that passive investors provide?

Ms. HERSETH SANDLIN. Mr. Ramm, has the PMA endorsed any of the legislative proposals introduced to date or any specific provisions in any of those proposals that, based on your testimony, would help restore the connection between commodity prices and supply and demand fundamentals?

Mr. RAMM. The portions of the bills presented to us currently are aggregate position limits set by the commercial entities that are then enforced by the CFTC. We think that by the markets getting back to the people that they were designed for—they talk about liquidity. I don't think a commercial would want a lack of liquidity. And I think that they would be able to and be the best people to set those position limits.

So with that, we think that a lot of—by doing that will take care of a tremendous amount of more of the problems, the swaps loophole, we think the FBOT loophole. If everybody was subject to those position limits, then we feel that that would take care of itself. I think it is time for the commodity markets to be given back to the people they were designed for. They weren't designed for Wall Street.

Ms. HERSETH SANDLIN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

The gentlelady from Kansas.

Mrs. BOYDA. Thank you very much, Mr. Chairman.

To Mr. Marshall I say, amen. I am glad to hear what you say. We wake up to news this morning about Fannie and Freddie, and we have had to have a Bear Stearns bail-out because they have gotten too big. Fannie and Freddie are so close, it is frightening the American people.

I will tell you, the American people want us to be very, very prudent in what we are doing. And I think the reason that we are having all of these hearings is each one of us understands that we can overstep. And so I would say to you on the commodities side, on the market side, that you need to be working with us, because as—we are representative of the American people, and the American people are pretty sick and tired of hearing that the market fundamentals are all intact and not to worry. So to the extent that you can say, here is what we can do, you will gain credibility with us, you will gain credibility with the American people, and, quite honestly, will come up with a better solution.

I would ask you, again, and to each one of you, Mr. Greenberger and Mr. Ramm, of the bills that we heard discussed among the House proposals, which one of those were you most worried about, came closest to what you all were thinking? Are you two in agreement by any chance, pretty close?

Mr. GREENBERGER. I don't know the answer to that. I know I like Mr. Ramm very much.

Mrs. BOYDA. And Mr. Young and Mr.—we all like each other.

Mr. GREENBERGER. Let me just say there are lots of pieces of legislation. I would tend to support those that call for the greatest regulation. And the PUMP Act is one of them, the Van Hollen-DeLauro bill is another.

But I will say where I am sitting right now, I think there is a lot of momentum behind the kind of proposals that Mr. Marshall made, and I think those proposals would have a tremendous therapeutic effect.

Mrs. BOYDA. Help me understand this. Is what Mr. Marshall saying closest to one of the bills that we heard?

Mr. GREENBERGER. There are some bills—for example, there is a bill on the House side that has aggregated speculation limits, and what that essentially means——

Mrs. BOYDA. Which one was that?

Mr. GREENBERGER. Part of Mr. Stupak's bill. It is a part of it, it is not the bill. Senator Lieberman and Senator Collins on the Senate side, this has been a big mission of theirs. They have held several hearings.

Mr. MARSHALL. Would the gentlelady yield?

Mrs. BOYDA. Sure.

Mr. MARSHALL. I wasn't talking about aggregate position limits applying to all markets.

Mr. GREENBERGER. Okay.

Mr. MARSHALL. And that consequently—there are two possibilities here. An aggregate position limits applying to all markets would be one. Another would be position limits as it affects the futures markets alone, the regulated markets. And the advantage of not doing an aggregated position limit affecting all markets is it leaves the market participants free to—if people are willing to take the risks, they are big boys, what have you, in a soft market, that is okay. They just can't lay that risk that is noncommercial, nonphysical, they can't lay it off in the futures market, regulated futures market.

Mr. GREENBERGER. Thank you for the clarification.

Mrs. BOYDA. I want to reclaim my time, too. I think we will come back to it. Are we going to do one round or more?

The CHAIRMAN. Well, probably one.

Mrs. BOYDA. There were some things that I don't understand. When you look in 2005, it looked like the annual or the average world supply daily, these are the figures I have: 84.63 million barrels a day. That is what we were producing. I think the actual production capacity is more like 86½, has been. In 2007, it actually went down a few hundred, so it is not dramatic. But the fact that it didn't go up is pretty dramatic, and today it is still right around in that area. And yet we have seen gas or oil go up from about $37 to close to $150 without any real—the Americans cut back. China, India have moved forward some, but we haven't seen any big tilt.

One thing we keep saying, this is all about the dollar, and I definitely am concerned about the weak dollar, don't get my wrong, but we have seen—in the last 6 months we have seen the dollar decline by less than eight percent against the Euro, and yet there is an unexplainable 50 percent increase in the price of oil.

I am kind of with Mr. Marshall. I was really—if you had given me a pop quiz and said you had to choose, a few weeks ago I would have said this is market-driven. The more you look into it, some of this just doesn't hold. Do you have any comments on how I can get that straight?

Mr. YOUNG. Well, I don't know that I have a perfect answer, but I would just suggest the following. If you looked at the dollar decline over time, so let us say go back 2 years, and you apply the value of the dollar to the price of crude oil today, from 2 years ago to today's price, you would have a lower price by around 20, 25 percent.

Now, Mr. Greenberger—I think, Mike, I have this right—I think there was some quantification or attempt to quantify what the so-called speculator premium was in the price today. And I think you said something like four or five percent yesterday. Maybe I got that wrong.

Mr. GREENBERGER. No. What I said yesterday was even if it was just four or five percent, it shouldn't be——

Mr. YOUNG. That is just to give you an order of magnitude, it is not that I know these numbers cold. My real point is unfortunately it is a more complicated issue than it has ever been before because of the globalization of our marketplace.

Mrs. BOYDA. In January we had about $450 million going into the speculation in a week, and by March it went up to $3.4 billion. That is just in terms of orders of magnitude about one.

Mr. YOUNG. Did you say in wheat?

Mrs. BOYDA. No, no, no. In oil.

Mr. YOUNG. But that speculation was long and short.

Mrs. BOYDA. I understand.

Mr. YOUNG. So if it is long and short——

Mrs. BOYDA. No, I understand. You have a buyer and a seller and all of that. I understand.

Mr. YOUNG. It shouldn't have that much of an effect on price.

Mrs. BOYDA. I agree it shouldn't have, but empirical data——

Mr. YOUNG. People must think the price is going up, that is the problem.

Mr. PENIKET. I think we are at the stage where the market is fundamentally readjusting its expectations. I think you had an interaction between three key things that have happened. We can all discuss how much the movement in the dollar has had an impact on the price of oil. Clearly it is a significant factor.

I think there are two other things. First, the supply is pretty constrained, and demand has not responded to the price signals that have come to the market in any significant way in the last 12 months. It may be that that starts to happen now. The market doesn't expect that to happen.

The other factor is that the market is looking ahead seeing very strong rates of growth in India and China, extrapolating that out over the next few years, and expecting the oil prices are going to move progressively higher. Not as a result of what is going on in the United States or Europe particularly, but because of very substantially increasing demand coming out of Asia. So it does come back to a market view that is being taken in terms of the expectation about the supply and demand fundamentals.

Mr. RAMM. One thing, if you lay up the price of the risk of the dollar off on oil, it distorts the price discovery system for oil. They are using it as the hedge for the dollar instead of the oil itself, the commodity itself. That is one of the problems we have. The currency shouldn't be—the oil commodity market shouldn't be used as a hedge against the dollar, oil should be. That wasn't designed to do that.

Mrs. BOYDA. I see.

Mr. RAMM. That is what it is being used for.

Mrs. BOYDA. I would love to continue, but I yield back.

The CHAIRMAN. I thank the gentlelady. Maybe I will jump in here.

This kind of goes to what I have been wondering about. The more I hear about this, I think I agree with Mr. Marshall that there is something going on here. I am not exactly sure what. I get the sense that a lot of people are trying to have the futures market regulate something they don't like, which is these crazy—all these credit swaps and derivatives and all the other stuff that is been invented out there by all the geniuses that you guys hire. My question is why aren't we regulating that stuff? Why did we let these credit swaps destroy the housing market? Who in the hell was watching the store?

And the more I look into these things, I wonder if we should even have some of these products. And you know this is not our jurisdiction. We can't do anything about this if we wanted to. And like pension money, I don't think it should be in the commodity market. But we can't control that because we don't control ERISA.

So people are coming in here wanting us to put all these parameters on things to try to keep people from doing this stuff when maybe we ought to be looking at the source of this. And I think we can have some effect here and maybe we will have. But I guess I would like any of you that might have any comments on that, should we be doing some of this stuff? Are we luring people into things that are going to be a big problem, blow up in our face and then we get blamed?

Mr. GREENBERGER. Mr. Chairman, we——

Mr. YOUNG. Mr. Chairman——

Mr. GREENBERGER. With regard to credit default swaps, I don't know how that—what the originator of that was. But that was in the Commodity Futures Modernization Act. Swaps, financial swaps were deregulated from Federal law and almost all state law. In fact, the New York Insurance Superintendent has taken the position, the swap involved is to give the bank a premium and the bank will guarantee the financial assets. Bear Stearns never set aside a capital reserve.

The CHAIRMAN. Right.

Mr. GREENBERGER. That was allowed by section 2(g) of the Commodity Futures——

The CHAIRMAN. Well, I understand that. So that created an opportunity for that market. But there are other Committees, and there are people in the United States Government that have the ability to look at these things and decide whether they make sense or not, right?

Mr. GREENBERGER. Mr. Chairman, I think a lot of people think that that is your jurisdiction.

Mr. YOUNG. Mr. Chairman, I would have hated to have been on *The Gong Show* with Mr. Greenberger. Let me try to add some history to this.

Before Congress ever thought about the 2000 Act, there were swaps. And some of them were called equity swaps. And some of those swaps, a lot of those swaps were done not in the United States, they were done overseas because of legal uncertainty in the United States. And as a result of that, our regulators had less transparency, less access to information about that trading activity.

The 2000 Act, by creating the very legal certainty that Mr. Greenberger just attacked, brought those swaps back to the United States, gave regulators a better handle on them——

The CHAIRMAN. Maybe brought them back but we don't understand—we don't have enough information to know what is going on with these things.

Mr. YOUNG. I understand. And that is my second point. And allowing for well-established time-tested systems like clearing systems and additional price transparency in those markets that have made those markets safer. Now, the credit default swap market is not yet subject to exchange trading. It is not yet subject to a clearing system. I know that the Chicago Mercantile Exchange testified this week in favor of doing that. That seems like a very solid idea based on the history in this area. But to say that Congress in 2000 somehow allowed the credit default swap to blossom—market to blossom I think is just inaccurate.

The CHAIRMAN. I understand that. And a lot of people don't and I agree with you.

Mr. GREENBERGER. Well, let me just say I don't agree with that. I am not going to take time.

The CHAIRMAN. Well, I know there is a disagreement here. But my staff tells me that this stuff was going on before 2000.

Mr. GREENBERGER. In the United States in, the United States it was going on.

The CHAIRMAN. Yes.

Mr. GREENBERGER. But that was the problem. It wasn't legal so they deregulated it.

Mr. YOUNG. Well, it was legal. Excuse me. It was legal. That is not accurate.

The CHAIRMAN. Well, bottom line, my concern as Chairman of this Committee is if this thing blows up, I would rather—I don't care if it is in a foreign country. They are the ones that screwed it up, not us. What I want to do is make sure that whatever we do here, that we don't let something happen on our watch in this Committee similar to what happened with these securitized mortgages.

Somebody should have been watching that. There is no way they should have ever let them sell those things. And the guys that sold them made a fortune and they are out in the Virgin Islands having a good time and the government is bailing them out. And I don't know exactly how much of this is heading for that kind of a situation. But I don't want it to happen on my watch. So that is where I am coming from.

Mr. RAMM. Mr. Chairman, I believe that if you apply capital market fundamentals to the commodity market, you are going to have trouble. They aren't capital markets.

The CHAIRMAN. Well, I understand that. That is what I am saying. This is not our business. Somebody in the Congress here should be watching this—in the Energy and Commerce Committee or the Financial Services Committee that actually have the jurisdiction over these instruments. We don't. That is my point, is that this Committee is not—our job is to make sure that the futures market works properly and that this is not manipulation. And maybe we do allow some of these things to develop because of some

of these loopholes that we have allowed, and that is what we are going to look at. But it is mixed up in more than just what we are doing.

Mr. RAMM. Mr. Chairman, and I hope you would agree that the commodity markets formed for beginning farmers.

The CHAIRMAN. For what?

Mr. RAMM. For farmers.

The CHAIRMAN. Yes. I understand.

Mr. RAMM. And for the people that actually touch the physical commodity.

The CHAIRMAN. Right.

Mr. RAMM. And we have to get it back into their hands. Say if all farmers and all oil producers decide that the markets are completely gone, these guys don't have a market anymore.

The CHAIRMAN. No. And that is the other concern of this Committee. What is going on in energy, bottom line my biggest concern is that if we do something here that you know they say, "Well, we are going to do this with energy, and we are not going to do it in agriculture, don't worry about it," that this thing is going to morph over to the agriculture market and screw us up. Because I am not an oil guy. I don't have any oil. We would love to discover oil in Minnesota, but I don't think it is going to happen.

Mr. RAMM. You never know.

The CHAIRMAN. My concern is that we protect the agriculture. But I have gone over my time. Who is next? Mr. Kagen.

Mr. KAGEN. Thank you, Mr. Chairman. I appreciate all the expert testimony here today. And I would like to help everyone to begin to think a little bit differently. I would like you to consider that oil might just be, as essential as it is, make the analogy that it might be the essential medication that every one of my constituents in northeast Wisconsin requires just to survive. We do, after all, live in our cars in a rural area. We live in our cars to go to work, live in our cars to get to business. The oil distributors need to be able to purchase the oil at a price they can afford to pay, just as the consumers, the people I represent, hard-working people in Wisconsin, have to dig deeper and deeper into their pocket to pay the $4 plus per gallon for the gasoline just to get to work.

So if you would begin to think with me that oil is not really a commodity but an essential pill, it is a medication that every single person in my district requires. Now who should be able to buy that pill? If this pill were available for sale to people that didn't need it, and now somebody in the ICE Futures or somebody in another country has purchased a whopping 75 percent of that available medication. Now it is not available for the people that really need it, what are people doing buying that medication if they don't have to take it? So why would we allow people to purchase the oil if they are not going to use it in their business or use it as a consumer? The people that are investing and making money or losing money in these markets are making and losing money on the change in the price of this product. But at the same time, the people I represent need it to survive. It gets cold in northern Wisconsin. People need the energy to put in their car, to fuel their homes and make sure that they can survive. What are we going to do when we come to the point where somebody corners the market for essential heart

medication or an asthma medication like Albuterol? What are the asthmatics going to do if it is just not available because they cannot afford the medication they need? It is already happening in health care. People go to the pharmacy, stand at the counter, see the medication they need, and they can't afford to buy it. And that is happening at the gas stations. And it is happening in the industry of oil delivery of the people I represent.

So I don't know where the solution is going to be on this. But I do have some questions as to who is messing with the markets and cornering the market, taking positions in oil, locking it up in their computer and not making it available at prices we can afford to pay.

So Mr. Peniket, I have a question for you. What effect would it have on your business, on the price of oil? And what effect would it have on the transparency of the markets, the dynamics of what is going on, if everyone who is purchasing oil contracts had to take possession of the oil that they buy?

Mr. PENIKET. In terms of the business that we do around crude oil, both of our crude oil contracts, Brent and WTI, are cash settled contracts. So nobody is buying any oil. They are transferring risk around the future movements in the price of oil.

Mr. KAGEN. But they are not in the business of buying the oil for distribution to 1,200 or 1,500 gas stations, are they?

Mr. PENIKET. Many of the people who use our marketplace are in the business of supplying oil or in the business of using oil and they are hedging price risk as they go forward. People are coming into the market and taking on some of that risk.

On your point in respect to the hoarding of the commodity, clearly if there was hoarding of a commodity that would point to market manipulation. There is no evidence——

Mr. KAGEN. Let me interrupt because I only have another minute and 5 seconds. Why would they be buying a pill if they didn't intend to take it, if only to mark up the price and they could profit by acquiring it?

Mr. PENIKET. People speculate around future price movements in order to make a profit.

Mr. KAGEN. Well, at some point don't you think it is the role of government to step in and say, "Look, you need this medication and you don't, you don't have the right to keep that medication from the very patients that require it. You don't have the right to own the oil that people need to heat their homes."

Mr. PENIKET. But going back to the role of the futures market, the role of the futures market is for participants in the market to manage their price risk. If people are unable to manage that price risk, then there is going to be no benefits to the consumer around that. If somebody is hoarding oil, that is a different question, and that is away from the role of the oil futures market.

Mr. KAGEN. Mr. Ramm, do you have another opinion on this?

Mr. RAMM. Well, I would say that today that the futures market dictates price and that price—and I think there was an example of it yesterday. Heating oil went up 16¢—around the United States it went up from 15¢ to 16¢ to 17¢ a gallon. That futures price was influenced by investors' money. It wasn't influenced on that day by any supply disruption. Maybe something in the news that hap-

pened in Iran, that might happen. But it affected the American consumer today.

Approximately, 924 trucking companies went out of business in the first quarter of this year. There is going to be over that in the second quarter. Our trucking industry is getting destroyed. People are not going to be able to heat their homes in northern Wisconsin because they won't be able to afford it. They are going to have to pick between food and fuel. That is a terrible thing that is starting to happen.

The price of fuel, the price of crude today does not need to be at $140 a barrel. It doesn't need to be that high. The thing that is forcing it to be that high is the price discovery system that is happening in a dysfunctional futures market. We need to get something done about this now.

Mr. KAGEN. I see my time has elapsed, and I will yield back.

The CHAIRMAN. We thank the panel for their testimony and call on panel two.

We have Mr. Terrence Duffy, Executive Chairman, CME Group, Chicago. Mr. Kendell Keith, President of the National Grain and Feed Association, Washington, D.C. And Mr. John Johnston, independent trader from Morristown, New Jersey.

Mr. Duffy, when you are ready, you may proceed.

**STATEMENT OF TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN, CME GROUP INC., CHICAGO, IL**

Mr. DUFFY. Thank you. I am Terrence Duffy, the Executive Chairman of the Chicago Mercantile Exchange. I want to thank the Committee for giving this opportunity to present our views.

The CME Group exchanges are a neutral marketplace. They serve the global risk management needs of our customers, producers, and processors who rely on price discovery provided by our competitive markets to make important economic decisions. We do not profit from higher food or energy prices. Our Congressionally mandated role is to operate fair markets that foster price discovery and the hedging of economic risks in a transparent self-regulated environment overseen by the CFTC.

My theme today is direct and indisputable. Even if every economist and every Member of Congress had genuine evidence that excessive speculation was distorting prices, it would be a monumental mistake to try to cure that problem by mandating an arbitrary increase in performance bond, commonly called margin, above prudent levels.

First, the impact would be more likely to drive prices in favor of the speculators and counter to the desired outcome. Second, arbitrarily high performance bond is the equivalent of a toll or a tax on the use of regulated markets. Its effect would be to drive trading offshore or into unregulated venues in clear contravention of the purpose of having well-regulated markets in this country.

For the record, it is essential to report that we see no evidence whatsoever that excessive speculation in futures markets is distorting prices. We renewed our research on this topic earlier this year when we were inundated with unverified claims that driving speculators from futures markets will bring commodity prices, in particular oil, back to some correct lower level. Fortunately, in ad-

dition to our own research findings, enough time has passed to permit a strong counter from economists and editorial writers, debunking these false claims.

Nonetheless, legislation has been proposed to mandate margin increases which would require hedgers and speculators to increase the level of performance bond required to guarantee performance of their contractual obligations to the clearing house.

One bill attempts to limit the increase to speculators who are not the counterparties to hedgers. The questionable theory behind this legislation is that the increased cost will drive speculators out of the futures markets. That prices will retrench to more comfortable levels because speculators with long positions are assumed to have caused price escalation in the first place.

This idea is seriously flawed and reflects a lack of understanding on the role of margin in futures markets. Given the critical juncture of policy deliberations, it is imperative that Congress recognize the falsities behind the demand to use margin increases to control commodity prices.

First, advocates of arbitrarily raising margins assume that speculators are all on the wrong side of the market, and this herd approach to trading has driven prices above their legitimate equilibrium level. All of the leading academic work in the field as well as our extensive studies support the opposite view; namely, that speculators are about equally divided on both sides of the market.

Second, increasing margins to artificially high levels will most likely cause a price spike rather than systemically lessen commodity prices. Moreover, mandated price by direct price control or by indirect actions distort future production and cause costly misallocation of resources of production.

Third, the imposition of an artificially high performance bond is a tax on trading as it raises traders' costs. This has been repeatedly demonstrated and even more so as markets have become electronic and available from anywhere around the globe. Indeed, excessive performance bond levels drives users away from transparent, regulated U.S. futures markets into opaque, unregulated over-the-counter markets. And remember, OTC markets have less liquidity, less price transparency and no public accounting for traders' positions. This is a net loss to the Congressionally defined purpose of creating fair, efficient and well-functioning energy and commodity markets.

Raising the margin to drive speculators on the wrong side of the market out of the market in a time in upward trending prices does not work. The speculators who have been wrong have been collecting the profits on their positions. They are in an especially strong position to meet any additional margin calls. Moreover, they are well aware that commercial hedgers on the short side of the market have been losing money and probably have been forced to borrow to support their short hedges. Therefore, they will be pressed to meet increasing margin calls and forced out of the markets. Furthermore, there is no evidence that artificially increased performance bonds will drive well-capitalized index funds or other passive long only investors to sell, nor is there any evidence that the impact of any such selling would be beneficial and positive for hedgers and commercials using the futures market.

Long index traders will not be driven from the market because they already have a fully collateralized account that is held on behalf of their clients. By increasing the amount of those funds that are required to be posted for margin, the index trader just transfers Treasury bills from one account to an account accessible to the clearinghouse. There is no cost to this class of trader.

One of the pending bills attempts to deal with the adverse impact on hedgers by giving relief to the speculator on the opposite side of the hedger. There is no such person. Every hedge transaction invites a chain of speculators as counterparties over its lifetime. In fact, the counterparty to every futures contract is a clearinghouse, not any identifiable speculator. Therefore, this approach will not work.

While the suggestion that margin increases can cure inflation and reduce the cost of oil by 30 to 40 percent is understandably seductive on a political level, Congress can ill afford to make a misstep in this regard. The downside risk of arbitrarily mandating increased margin for futures is enormous. Congress' credibility is at risk in adopting simplistic, ill-conceived responses that are destructive to U.S. futures markets and those legitimately relying on those markets.

I thank you for your time this morning.

[The prepared statement of Mr. Duffy follows:]

PREPARED STATEMENT OF TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN, CME GROUP INC., CHICAGO, IL

I am Terrence Duffy, Executive Chairman of Chicago Mercantile Exchange Group ("CME Group" or "CME") Thank you, Chairman Peterson and Ranking Member Goodlatte, for this opportunity to present our views.

CME Group was formed by the 2007 merger of Chicago Mercantile Exchange Holdings and CBOT Holdings. CME Group is the parent of CME Inc. and The Board of Trade of the City of Chicago (the "CME Group exchanges"). The CME Group exchanges are neutral market places. They serve the global risk management needs of our customers, producers and processors who rely on price discovery provided by our competitive markets to make important economic decisions. We do not profit from higher food or energy prices. Our Congressionally mandated role is to operate fair markets that foster price discovery and the hedging of economic risks in a transparent, self-regulated environment, overseen by the CFTC.

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. We also offer order routing, execution and clearing services to other exchanges.

**I. Increased transparency through imposition of reporting requirements for foreign boards of trade and other platforms is appropriate.**

We unequivocally support your efforts to materially improve the enforcement capabilities and machinery of the CFTC and to do so in a manner that does not increase the costs of trading on fully regulated U.S. contract markets. We also are enthusiastic supporters of broadly expanding the mandatory reporting of energy trading and position information to the Commission. We share the view of regulators and legislators most famously expressed by Justice Louis Brandeis:

> "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."
>
> —Justice Louis Brandeis, *Other People's Money, and How the Bankers Use It,* 1933.

We believe that disclosure of trading and position information to a regulator with sufficient resources to analyze and act on unusual or suspicious activities will deter most potential manipulators and assure punishment of those foolish enough to at-

tempt a manipulation when all of their actions are visible to the regulator. This is the philosophy upon which our internal market regulation has been based and why it has been so successful.

We also clearly understand that the recent surge in the prices of many commodities, particularly energy, has inspired Congress to look for assurance that the only price drivers are legitimate supply and demand factors. Some who claim expertise or special knowledge have asserted that the entire price inflation can be laid at the door of speculators and/or passive index funds that have invested billions in commodity contracts. The more cautious critics have suggested that there may be a froth of inflation caused by speculation. Our careful, up-to-date evaluation of market participants and trading patterns in the commodities traded at CME and CBOT are to the contrary. We have placed relevant information on our website, which will permit others to review our findings to date respecting the impact of speculation on our markets.

Our economists make convincing arguments that neither speculators nor index funds are distorting commodity prices. Previous studies have concluded that speculation has not been responsible for any significant, persistent volatility in futures markets. Nonetheless, we are strong proponents of securing all of the relevant information from all sources and fairly testing the hypothesis and reconfirming previous academic studies. While we expect that the evidence respecting the impact of speculation and index trading in energy markets will parallel the results we have found in our own markets, we agree that there is no reason to rely entirely on economic theory when the data is or can be made available. We support the efforts of the CFTC and Congress to secure this data and to assure that a thorough analysis informs any subsequent legislative or administrative efforts to deal with uneconomic price inflation.

Increased reporting on swaps transactions would provide much needed transparency to these unregulated markets. The CFTC should have access to this data so that it can make an informed decision that speculation is not leading to a premium in the price of energy commodities. We recommend that the reporting requirement not be linked to exchange-traded transactions so as not to drive business off fully-regulated exchanges.

**II. Position limits on foreign boards of trade listing clones of U.S. DCM listed contracts.**

Position limits are a device to promote liquidation and orderly delivery in physical contracts. If two markets share the same physical delivery contract it is consistent to apply a single limit across both markets. However, we are not aware of a foreign board of trade that lists a physically deliverable futures contract that is a clone of a U.S. designated contract market's (DCM) listed contract.

The ICE U.K. market lists a WTI crude oil contract that is traded and settled based on the settlement prices of the NYMEX WTI contract. The ordinary reasons for imposing position limits on futures markets do not apply in such a case. It is possible to imagine a trader who is long a limit position at NYMEX and double that position at ICE U.K. That trader might expect to profit, if not caught, by driving up the settlement price on the final day of trading on NYMEX by standing for delivery, even though he would be required to store and then sell the oil back at a loss, in the hope to profit from the settlement on ICE. Of course, such behavior will be obvious to the regulators and the markets and the manipulator would neither enjoy the profits nor much additional freedom. Moreover, the impact on the price of oil would be transitory.

Setting aside theoretical understanding, we support a temporary imposition of position limits on the ICE Futures U.K. WTI contract until the CFTC is able to secure and analyze a more complete data set respecting the impact of speculation and/or indexed commodity trading on price inflation. We do not imagine that any harm will be done and this action will allay concerns.

**III. The exemption for commercial markets in energy products, even as limited by the recent amendment of the CEA, is unnecessary and creates information gaps.**

In the aftermath of the Amaranth controversy, Congress provided CFTC new authorities in the recently enacted farm bill to regulate "significant price discovery contracts" on platforms like ICE by requiring those platforms to meet certain core principles drawn from the longer list applicable to fully regulated exchanges. It is clear that when Congress wants to ensure fair dealing and regulatory propriety, it uses as its comparative yardstick the regulatory regime imposed on America's fully regulated exchanges.

Trading that is conducted on fully regulated exchanges is an open book to which you already have complete access and accountability. Indeed, CFTC monitors that exchange trading daily and has repeatedly opined that speculation on those fully regulated exchanges does not raise regulatory concerns. But that is not the case with the other forms of energy commodity trading, which lie outside the reach of CFTC regulation and are far larger in size in terms of trading volume.

Section 5(b) of the Commodity Exchange Act charges the Commission with a duty to oversee "a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals" and "to deter and prevent price manipulation or any other disruptions to market integrity; to ensure the financial integrity of all transactions subject to this chapter and the avoidance of systemic risk; to protect all market participants from fraudulent or other abusive sales practices."

These "purposes" and the statutory exemption for Commercial Markets found in Section 2(h)(3) are in conflict. The key purposes mandated by Congress in Section 5(b) are jeopardized if trading facilities for contracts in exempt commodities are permitted to coexist with regulated futures exchanges that list those same commodities. Exempt Commercial Markets (ECMs) do not have any system of "effective self regulation" of their facilities or of their market participants. Their contracts are traded based on the prices of commodities that have limited supplies and that have often been the subject of manipulative activity and disruptive market behavior. There is no mechanism in place "to deter and prevent price manipulation or any other disruptions to market integrity." The Commission cannot track the build up of dominant positions. At best, the Commission has power to punish such conduct after the fact. We find this to be a serious problem that is at odds with Congress' intent behind the CFMA, which, if left unaddressed, jeopardizes the public's confidence in the CFTC's ability to do its job.

The Section 2(h)(3) exemption for unregulated commercial markets should be eliminated. You cannot fix the problem by merely changing reporting requirements. In order to secure accurate reports, a market needs an effective surveillance and compliance system. This requires that an effective system of self regulation must be put in place. The logical conclusion is you must implement at least the core principles required of a derivatives transaction execution facility (DTEF) to get a useful result.

## IV. Mandating an arbitrary increase in margin for futures above prudential levels is counterproductive and potentially destructive to U.S. futures markets and Congress should reject calls to do so.

Beginning several weeks ago, there was a strong suggestion that driving speculators from the markets will bring commodity prices, in particular oil, back to some "correct" level below what exists today. Worse still, these critics argue for driving speculators from the market by government-mandated increases in margins. The most prominent witness before Congressional Committees was a large speculator in airline and automobile stocks that may have benefited from the precipitous actions he advocated. Fortunately, enough time has passed to permit a strong counter-current from economists and editorial writers debunking those claims.[1]

Nonetheless, legislation has been proposed to mandate margin increases, which would require hedgers and speculators to increase the level of performance bonds required to guarantee performance of their contractual obligations to the clearing house. The theory behind the legislation is this: increased costs will drive speculators out of the futures markets and prices will retrench to more comfortable levels, because speculators with long positions are assumed to have caused price escalation in the first place. This idea is seriously flawed and reflects a lack of understanding of the role of margin in futures markets.

The discussion of margin increases during recent congressional hearings makes it abundantly clear that many legislators wrongly assume the concept of margin in futures markets is similar to that in equity markets. In other words, they think of it as an extension of credit or a down payment on the cost of a security. However, the notion of "credit" has nothing to do with the concept of margin as used in futures markets. In futures markets, margin is not an extension of credit. Rather, margin is the equivalent of a performance bond designed to ensure that contractual

[1] Attached to our testimony are four noteworthy pieces published in recent days. (1) "Oil Speculation." FINANCIAL TIMES. Retrieved July 3, 2008 from *www.FT.com.*; (2) "For Love of Speculators." CHICAGO TRIBUNE. Retrieved July 2, 2008 from *www.chicagotribune.com.*, this document is copyrighted and available for a fee from THE CHICAGO TRIBUNE; (3) Nocera, Joe. (June 28, 2008) "Easy Target, but Not the Right One." NEW YORK TIMES.; (4) Samuelson, Robert J. (July 1, 2008) "Who's Behind High Prices." WASHINGTON POST, A11.

obligations are met and that clearing houses can fulfill their responsibilities. Margins are not intended to create incentives or disincentives for trading decisions.

In futures markets, margin—aka performance bond—is set at a level to cover, with a high degree of confidence, any change in the underlying value of a futures contract during a single day of trading. It has nothing to do with the notional or face amount of the contract. For example, performance bond on a $36,700 CBOT corn contract is currently set at $2,025, while performance bond on a $100,000 thirty year bond contract is set at $3,510. In each case, the holder of the contract must make good on his losses and conversely gets credit for his gains on a daily basis. Our clearing system continuously holds 100 percent collateral for a near worst case loss scenario. The cost of depositing collateral or cash with the clearing house is considered a cost of trading.[2]

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. So do the rest of the world's futures markets, a majority of which utilize the same concept of margin created by CME Group. Mandating arbitrary margin levels would not improve the functioning of energy and commodity futures markets and would interfere with the prudential risk management practices of central counterparty clearing houses. To urge Congress to arbitrarily interfere with this well-functioning system of margin invites substantial risk to the proper functioning of futures markets. Given the critical juncture of policy deliberations, it is imperative that Congress recognize the fallacies and misunderstandings that are prompting calls to meddle artificially with this time-tested margin concept.

First, advocates of arbitrarily raising margin assume that speculators are all on the long side of the market and that this herd approach to trading has driven prices above their legitimate equilibrium level. All of the leading academic work in the field, as well as our extensive internal studies, support the opposite view—namely, that speculators are about equally divided on both sides of the market.

Second, the imposition of artificially high performance bonds is a tax on trading as it raises a trader's cost. This has been repeatedly demonstrated, and ever more so as markets have become electronic and available from anywhere around the globe. Indeed, excessive performance bond levels drive users away from transparent, regulated U.S. futures markets and into opaque, unregulated OTC markets. And remember, the OTC markets have less liquidity, less price transparency and no public accounting for traders' positions. This is a net loss to the Congressionally defined purpose of creating fair, efficient and well-functioning energy and commodity markets.

Our extensive market regulation experience—and our experience with previous efforts to control commodity prices by means of adjusting the level of performance bond—have established the fact that artificially increasing margins is not effective. Raising margins to drive speculators on the long side of the market out of the market in a time of upward trending prices does not work. The speculators who have been long have been collecting the profits on their positions. They are in an especially strong position to meet any additional margin call. Moreover, they are well aware that traders on the short side of the market have been losing money and probably have been forced to borrow to support their short hedges. Therefore, they will be pressed to meet increased margin calls and forced out of the markets.

A North Dakota farmer who sold corn futures at a new high of $5 a bushel and locked in a $2 per bushel profit needs to be able to carry his hedge until his crop is harvested. A single contract is 5,000 bushels and margin is now set at $1,000 per contract. Assume the farmer had sold 100 contracts. Corn was $7 this morning and the farmer has been forced to go to his bank to borrow $2 × 5,000 × 100=$1,000,000 to continue to carry the position. If margins are artificially raised to some arbitrary level, the long speculator will be in a very favorable position knowing that the short hedger is going to have to go to the bank and borrow millions more to hold his hedge position until his crop is harvested. The cost to hedgers can be even more drastic when the country is in the midst of a severe credit crunch.

Moreover, 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. Generally, these investors are

[2] We have attached hereto an article titled "SPAN: The First 20 Years" that succinctly describes CME's Standard Portfolio Analysis risk methodology for determining margin based on actual volatility risk, which revolutionized the management of futures and options risk worldwide and is the industry standard around the world today. FUTURES INDUSTRY MAGAZINE, pages 32–35 (March/April 2008).

not leveraged and are in the best position to margin up to 100 percent. Long index traders will not be driven from the market, because they already have a fully collateralized account that is held on behalf of their clients. By increasing the amount of those funds that are required to be posted for margin, the index trader just transfers treasury bills from one account to an account accessible to the clearing house. There is no cost to this class of trader.

One of the pending bills attempts to deal with the adverse impact on hedgers by giving relief to the speculator on the opposite side of the hedger. There is no such person. Every hedge transaction invites a chain of speculators as counterparties over its lifetime. In fact, the counterparty to every futures contract is the clearing house, not any identifiable speculator. This approach will not work.

Though it is tempting to view the current commodity market situation as unique historically, Congress may find it valuable to recognize the lessons arising from a period not so long ago when speculation in agricultural markets raised similar concerns as we are experiencing today. In a study published in June 2008,[3] University of Illinois Professors Sanders, Irwin and Merrin examined the agricultural markets of 1972 through 1975, the last period with comparable episodes of structural change marked by all-time high commodity price increases. The researchers indicated that the commodity environment was influenced by structural shifts such as oil embargoes, Russian grain imports, and the collapse of the Bretton Woods fixed exchange rate system. Their findings have particular relevance to the current situation facing our nation. Indeed, in the troubled context of the agricultural commodity markets of 1972–1975, commodity price increases were often blamed on speculative behavior associated with the tremendous expansion of futures trading in a wide range of commodities.

We find the conclusions reached by Sanders *et al.* to be very useful with regard to today's hearing:

> The complex interplay between these factors and how they impact price expectations is often difficult to grasp in real-time. So, much like the mid-1970's, the scapegoat for commodity price increases seems to have become the speculator. The present research suggests that current levels of speculation—given hedging needs—are at historically normal levels. Indeed, Working's T [an objective index of speculative activity] in many agricultural futures markets is at levels associated with 'inadequate' speculation in the past. If this is the case, then policy decisions aimed at curbing speculation may well be counter-productive in terms of price levels and market volatility. In particular, these policy initiatives could severely compromise the ability of futures markets to accommodate hedgers and facilitate the transfer of risk.

As in the 1972–1975 period, we can certainly understand how appealing it would be for Members of Congress to believe that increasing margin is a sure-fire, fast-track way to lower commodity speculation and in turn lower commodity prices—by perhaps 50 percent in 30 days. While the allure of this suggestion is understandably seductive on a political level, Congress can ill afford to make a misstep in this regard. The downside risk of arbitrarily mandating increased margin for futures is enormous. Congress's credibility is at risk in adopting simplistic, ill-conceived responses that are destructive to U.S. futures markets and those who legitimately rely on those markets.

**V. Speculation is essential to efficient, liquid markets. Congress should do everything in its power to avoid responses that threaten the vitality of futures markets.**

Current fuel and food prices are shocking and painful to consumers and the economy. Unfortunately, the pressure to reverse rising prices has led some to look for a simple, causal agent that can be neutralized with the stroke of a pen. The favored culprit is the traditional villain—speculators. But speculators sell when they think prices are too high and buy when they think prices are too low. They are not a unified voting block and are on both sides of every market. Speculative selling and buying send signals to producers and processors that help keep our economy on an even keel. High futures prices for corn induce farmers to bring new acreage to market. High forward energy prices encourage exploration and new technology to capture existing untapped reserves and foster conservation and other behavioral changes to adjust demand.

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[3] Sanders, D.R., S.H. Irwin, and R.P. Merrin. "The Adequacy of Speculation in Agricultural Futures Markets: Too Much of a Good Thing?" Marketing and Outlook Research Report 2008–02, Department of Agricultural and Consumer Economics, University of Illinois at Urbana—Champaign, June 2008. [*http://www.farmdoc.uiuc.edu/marketing/reports*]

Futures markets perform two essential functions—they create a venue for price discovery and they permit low-cost hedging of risk. Futures markets depend on short- and long-term speculators to make markets and provide liquidity for hedgers. Futures markets could not operate effectively without speculators, and speculators will not use futures markets if artificial barriers or tolls impede their access. Most important, blaming speculators for high prices diverts attention from the real causes of rising prices and does not contribute to a solution.

The weight of the evidence and informed opinion confirms that the high prices are a consequence of normal supply and demand factors. *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 . . . ."[4]

The traditional production/consumption cycle that has governed prices in commodity markets is stressed by the confluence of a number of factors. David Hightower, author of *The Hightower Report,* summed up the supply/demand situation in corn last year as follows: "We have experienced 3 consecutive years of record corn production and 3 consecutive years of declining ending reserves. Supply has put its best team on the field and demand keeps winning."

The headlines that are grabbing the greatest attention these days derive from the cost of energy commodities primarily traded elsewhere than CME Group's markets. Nevertheless, a review of our experience in the agricultural future markets that we do operate illustrates the predominant roles that non-speculative forces, and particularly the fundamentals of supply and demand, play in the economic challenges Americans face today. Based on our expertise in agricultural markets, we have identified five significant factors that are influencing the supply and demand for grains and oilseeds:

1. Weather/disease/pestilence.
2. Increasing per capita consumption in the emerging markets.
3. The dramatic impact of the demand for grain and oil seeds as feed stock for biofuel.
4. Reactionary governmental trade policies.
5. Financial Market turmoil, including a weakened dollar.

These factors combine to create volatile markets and increased prices.

1. *Weather/Disease/Pestilence:* This is of course a traditional factor in the grain markets. Wheat recently attained all-time record prices, coincident with 60 year lows in world stockpiles. In the past 2 years there have been production shortfalls in Australia, Argentina, Europe, North America, and the Ukraine due to a combination of drought in some places, untimely rains in others, and even infestation by the Eurygaster beetle.

2. *Per Capita Consumption in Emerging Markets:* Despite that some projections imply a slowing population growth during this century, global population is still growing, and from an ever increasing base. In the short-run, GNP 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. Commonly 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 exceeding 30 million tons in 2007. Never before in history have we witnessed the impact of two billion people asking for a higher standard of living at the same time.

3. *Growth in 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 2005 Energy Bill in the United States 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 2008–2009, up 28 percent from the current year projection. Ethanol corn will now account for 31 percent of total corn use, up from a projected

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

25 percent for 2007–2008." The amount of corn used in ethanol production just 5 years ago was approximately ten percent. In addition to the U.S. initiative, 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 the entire 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.

4. *Reactionary Government Trade Policies:* 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, Russia has placed an export ban upon its grain to the four CIS (Commonwealth of Independent States) members designed to prevent re-export of Russian grain to third countries. Argentina extended its wheat export closure through April 8, and announced a new, higher soy export tax that will rise by 7–9 percentage points 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 2007–2008 with projections currently up an additional 14 percent. 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. This trend results in increased demand for U.S. grain and oil seed products.

5. *Financial Market Turmoil:* The events that began in the subprime sector of the financial markets are now spreading out with very serious and negative consequences throughout the nation's banking sector. Restrictive lending policies are having deleterious effects within our marketplace. High volatility leads to higher margins, large directional price moves require significant continuing variation deposits, and all of this comes at a time when money is difficult to obtain.

The non-speculative factors summarized above all have a material impact on supply and demand in energy and agricultural commodity markets. Given these factors, it would be wise for Congress to examine rigorously any assertions that speculation is driving up prices in food or energy markets—before enacting any legislation in response. Policies that are based on factually invalid assumptions of speculation's role could be disastrous and impose additional, perhaps even greater, economic dislocation than the current impact of high food and energy prices themselves.

**VI. Participation in commodity markets by index funds, hedge funds and pension funds.**

We strongly oppose any effort to eliminate index funds from participating in the commodities markets. Index funds may rely on no-action risk-management exemptions to exceed position limits or they may enter into OTC transactions with a swaps dealer to gain exposure to commodities by benchmarking their OTC transaction to a broad-based commodity index. For index funds that obtain market access through a swaps dealer, the swaps dealer is often granted a hedge exemption as described above. For index funds that agree to track an index (as opposed to holding a swaps position directly linked to the price of an index), CFTC has determined that these index-based positions differ enough that a hedge exemption is not appropriate. Instead, the fund is granted no-action relief from speculative position limits for this otherwise legitimate investment strategy (subject to conditions to protect the markets).

Others have suggested excluding pension funds and index funds from participating in commodity futures markets. These funds are using commodity exposure to decrease volatility in their portfolios. Barring them from regulated U.S. futures markets will only push them offshore or into over-the-counter trading. These funds will continue to need commodities as an asset class and will need to find ways to invest on behalf of their clients. Certainly a number of foreign commodity futures exchanges offer comparable and liquid ag product alternatives in particular and could easily become the benchmark in these commodities should unreasonable barriers be placed on the U.S. markets. We believe it would be prudent public policy to ensure this investment occurs on a domestic regulated market instead of driving this capital overseas or into opaque markets.

CME Group has conducted a thorough review of the impact of index trading and speculative trading on its primary agricultural markets. We have found a negative correlation between price increases and index fund buying.

While we favor a broader study of the impact of index fund trading, we do not think it is appropriate to cast those funds as a villain in price inflation until the study is completed, especially since in theory it is not likely that the index funds

are having a detrimental impact. Index funds buy and hold. They may have some small impact on days when new money enters the market and they create additional net long positions, but those changes are transitory. The important statistic in this regard is *new net positions,* not overall positions.

After the flow of new money into the market from the index funds, the price will, in the absence of other factors, revert to the equilibrium dictated by current supply and demand factors because the index traders simply sit and hold the positions until they roll to the next delivery month. Traders making informed trades should be expected to drive the market to equilibrium.

All price changes take place at the margin as those traders with information, meaning that they are hedging or expressing an opinion based on knowledge, buy and sell. Even if 20 percent of the open interest in a particular contract month of a commodity is held by index funds, buying and selling by a few traders based on need and knowledge drive the market to its fair equilibrium price. The open positions of the index traders have no impact on prices driven by informed trading activity.

Beyond being subjected to the criticisms leveled at speculators in general, there have been more specific suggestions that money managers and hedge funds that operate under defined strategies may have impaired the price discovery process. The CFTC's staff responded to questions implying that managed money traders, particularly hedge funds, "may exert undue collective influence on markets and thus move prices in ways that hinder the market's price discovery role, reduce the effectiveness of hedges constructed with contracts from those markets and raise trading costs." CFTC's professional staff conducted an analysis in 2005 which came to the following conclusions: [5]

> Using a unique set of data from the Commodity Futures Trading Commission (CFTC), the staff studied the relationship between futures prices and the positions of managed money traders (MMTs), commonly known as hedge funds, for the natural gas and crude oil futures markets. The staff also examined the relationship between the positions of MMTs and positions of other categories of traders (*e.g.,* floor traders, merchants, manufacturers, commercial banks, dealers) for the same markets.
>
> The results suggest that on average, MMT participants do not change their positions as frequently as other participants, primarily those who are hedgers. The staff found that there is a significant correlation (negative) between MMT positions and other participant's positions (including the largest hedgers), and results suggest that it is the MMT traders who are providing liquidity to the large hedgers and not the other way around.
>
> The staff also found that most of the MMT position changes in the very short run are triggered by hedging participants changing their positions. That is, the price changes that prompt large hedgers to alter their positions in the very short run eventually ripple through to MMT participants who will change their positions in response. The staff also found no evidence of a link between price changes and MMT positions (conditional on other participants trading) in the natural gas market, and find a significantly negative relationship between MMT position changes and price changes (conditional on other participants trading) in the crude oil market.

In recent Congressional testimony, the CFTC has reaffirmed the validity of this 2005 analysis.[6] It is instructive that CFTC's analysis parallels the conclusions of many other economists who have also studied the issue of causation in the context of speculators and commodity futures prices.[7]

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[5] *http://www.cftc.gov/opa/press05/opa5074-05.htm.*

[6] During his appearance before the Senate Appropriations Committee on May 7, 2008, CFTC Acting Chairman Walt Lukken stated that the CFTC's recent revisitation of the 2005 study using more current data for energy market trading affirmed the conclusions reached in the 2005 study. This conclusion mirrors the views of the majority of 53 economists surveyed by THE WALL STREET JOURNAL in May 2008 which indicated that the global surge in food and energy prices is being driven primarily by fundamental market conditions, rather than an investment bubble. WALL STREET JOURNAL, May 9, 2008, page A–2. Similarly, the U.S. Department of Energy's Energy Information Agency's most recent "Short Term Energy Outlook" published May 6, 2008, evidenced the tightness in world oil markets, with growth in world oil consumption outstripping growth in production in non-OPEC nations by over 1 million bbls/day, and dramatically increased demand coming from China, India and other parts of the developing world.

[7] See, for example, Antoshin and Samiei's analysis of the IMF research on the direction of the "causal arrow" between speculation and commodity prices in "Has Speculation Contributed to Higher Commodity Prices?" in World Economic Outlook (September 2006):

Continued

Regulated futures markets and the CFTC have the means and the will to limit speculation that might distort prices or distort the movement of commodities in interstate commerce. Acting Chairman Lukken's recent testimony before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce United States House of Representatives (December 12, 2007)[8] offers a clear description of these powers and how they are used:

> CEA Section 5(d)(5) requires that an exchange, "[t]o reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month . . . shall adopt position limitations or position accountability for speculators, where necessary and appropriate."
>
> All agricultural and natural resource futures and options contracts are subject to either Commission or exchange spot month speculative position limits—and many financial futures and options are as well. With respect to such exchange spot month speculative position limits, the Commission's guidance specifies that DCMs should adopt a spot month limit of no more than ¼ of the estimated spot month deliverable supply, calculated separately for each contract month. For cash settled contracts, the spot month limit should be no greater than necessary to minimize the potential for manipulation or distortion of the contract's or underlying commodity's price. For the primary agricultural contracts (corn, wheat, oats, soybeans, soybean meal, and soybean oil), speculative limits are established in the Commodity Exchange Act and changes must be approved via a petition and public rulemaking process.
>
> With respect to trading outside the spot month, the Commission typically does not require speculative position limits. Under the Commission's guidance, an 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 his 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, in order to achieve the purposes of the speculative position limits, the Commission and the DCMs treat multiple positions held on a DCM's market that are subject to common ownership or control as if they were held by a single trader. Accounts are considered to be under common ownership if there is a ten percent or greater financial interest. The rules are applied in a manner calculated to aggregate related accounts.

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On the other hand, the simultaneous increase in prices and in investor interest, especially by speculators and index traders, in commodity futures markets in recent years can potentially magnify the impact of supply-demand imbalances on prices. Some have argued that high investor activity has increased price volatility and pushed prices above levels justified by fun damentals, thus increasing the potential for instability in the commodity and energy markets.

What does the empirical evidence suggest? A formal assessment is hampered by data and methodological problems, including the difficulty of identifying speculative and hedging-related trades. Despite such problems, however, a number of recent studies seem to suggest that speculation has not systematically contributed to higher commodity prices or increased price volatility. For example, recent IMF staff analysis (September 2006 World Economic Outlook, Box 5.1) shows that speculative activity tends to respond to price movements (rather than the other way around), suggesting that the causality runs from prices to changes in speculative positions. In addition, the Commodity Futures trading Commission has argued that speculation may have reduced price volatility by increasing market liquidity, which allowed market participants to adjust their portfolios, thereby encouraging entry by new participants.

Similarly, James Burkhard, managing director of Cambridge Energy Research Associates testified to the Senate Energy Committee on April 3, 2008 that: "In a sufficiently liquid market, the number and value of trades is too large for speculators to unilaterally create and sustain a price trend, either up or down. The growing role of noncommercial investors can accentuate a given price trend, but the primary reasons for rising oil prices in recent years are rooted in the fundamentals of demand and supply, geopolitical risks, and rising industry costs. The decline in the value of the dollar has also played a role, particularly since the credit crisis first erupted last summer, when energy and other commodities became caught up in the upheaval in the global economy. To be sure, the balance between oil demand and supply is integral to oil price formation and will remain so. But 'new fundamentals'— new cost structures and global financial dynamics—are behind the momentum that pushed oil prices to record highs around $110 a barrel, ahead of the previous inflation-adjusted high of $103.59 set in April 1980."

[8] *http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opalukken-32.pdf.*

> Violations of exchange-set or Commission-set limits are subject to disciplinary action, and the Commission, or a DCM, may institute enforcement action against violations of exchange speculative limit rules that have been approved by the Commission. To this end, the Commission approves all position limit rules, including those for contracts that have been self-certified by a DCM.
>
> It is clear that speculation is an important component of the futures markets, but there is a point when excessive speculation can be damaging to the markets. As a result, the CFTC closely monitors the markets and the large players in the markets, in addition to position and accountability limits, to detect potentially damaging excessive speculation and potential manipulative behavior.

On June 26, 2008, the House passed overwhelmingly H.R. 6377, directing the CFTC to utilize fully its authority, including its emergency powers, to investigate the potential role of excessive speculation in any CFTC regulated market. The CFTC was also directed to take appropriate action to curb any excessive speculation that may be found to exist that results in prices diverging from those reflecting the forces of supply and demand. In our view, H.R. 6377 is an understandable and appropriate response given the circumstances facing the markets. The bill respects the need to have dispassionate expert analysis of this highly technical matter *before* action is taken. Congress is not well-equipped to make these technical assessments and the public interest will be advanced and better protected by CFTC's careful and meticulous analysis. Moreover, our sense is that the CFTC well understands the urgency that underlined passage of H.R. 6377. We are confident that the CFTC is the right agency with the expertise to analyze the relevant derivatives markets in an expeditious and thoughtful manner and to take appropriate action commensurate with what the facts may dictate.

**VII. The CFTC's exclusive jurisdiction over trading on CFTC regulated markets must be preserved.**

CME Group recently joined with other leading participants in the financial services industry to respond to the Federal Trade Commission's (FTC) request for comments regarding its proposed rule respecting false reporting and manipulative activities in the wholesale oil market. We are concerned that the FTC's jurisdictional reach could come into conflict with the CFTC's exclusive jurisdiction respecting futures trading. While the statute very clearly limits the FTC's jurisdiction to conduct in connection with "the purchase or sale of crude oil, gasoline or petroleum distillates *at wholesale,*" the Federal Energy Regulatory Commission (FERC), which has similar authority, has read "in connection with" to give it authority over conduct that took place entirely on a futures exchange. This latest opportunity for incursion into CFTC's exclusive jurisdiction should be of high concern to the Agriculture Committee.

In 1974, Congress recognized the overriding importance of entrusting to the expertise of the CFTC the exclusive regulatory authority over the nation's futures markets. Congress preempted other Federal and state rules that would either assert parallel jurisdiction over the futures markets or produce conflicts with the CFTC regulatory regime. This system has produced the best regulated, most innovative and efficient futures market in the world.

As markets evolve and become more interrelated, such agency "boundary disputes" can be expected and, for the most part, the agencies usually take pains to accommodate one another and allow each to accomplish the mission Congress mandated for it. We are concerned by the FERC's claim of jurisdiction in the *Amaranth* case, where the alleged manipulative trading took place on a futures exchange. FERC has refused to recognize and yield to the CFTC's exclusive jurisdiction. The result is that participants in the natural gas futures markets no longer have legal certainty as to the legal standard governing their transactions.

By the same token, we have been concerned by recent calls to have other Federal agencies—the Department of Energy and the FTC in particular—take leading roles in investigating commodity markets that fall primarily within the exclusive jurisdiction of the CFTC. We strongly urge the Agriculture Committee to take special care in articulating the public policy wisdom of the exclusive jurisdiction bestowed long ago on the CFTC and the invaluable contribution that the CFTC's expertise can play in sifting fact from fiction amid the turbulence of the current market situation.

The recently enacted farm bill demonstrates the continued vitality of the CFTC's exclusive jurisdiction. Congress reauthorized the CFTC for another 5 years and granted the CFTC new authority to regulate certain exempt commercial markets that are active enough to constitute price discovery markets.

**VIII. Congress should increase the CFTC's resources.**

The spate of recent congressional hearings has established that the CFTC is working at staffing and resource levels that could inhibit attainment of the agency's Congressionally mandated statutory mission. Given that the CFTC is now expected to be even more aggressive in its oversight and enforcement, Congress should provide CFTC with additional funding to hire more personnel, acquire more technology, and do everything necessary to police the derivatives markets effectively. The enormous value that accrues to the public from effective CFTC activity warrants the investment of additional financial resources from general revenues.

**Conclusion**

CFTC regulated futures markets have demonstrated their importance to the economy, the nation's competitive strength, and America's international financial leadership. Imposing arbitrary increases in margins in these markets, as has been suggested as a way to control prices, will result in the exportation of these markets to overseas competitors and to unregulated and non-transparent over-the-counter markets. We have the means and the power to protect markets against speculative excesses on our markets and are committed to doing so.

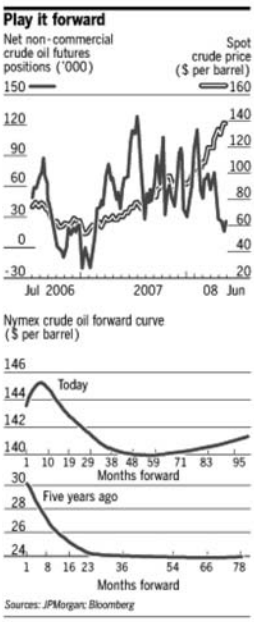
ATTACHMENTS

**Oil Speculation**

*Financial Times*
Published: July 3 2008 12:40
Last updated: July 3 2008 12:42

What would you do if you were a senator? Explain to Americans that reducing the oil price will involve trading in that truck for a Mini? Or blame it all on "speculators" and promise a quick regulatory fix?

No prizes for guessing which way sentiment is leaning in Washington. Those blaming speculators for high crude prices reason that the marginal cost of producing a barrel is about $75. The current oil price is almost double that figure. Clearly, much money has gone into commodities recently. Therefore, speculation explains the "excess" and clamping down on it should push prices down.




This simplistic argument blithely ignores fundamental supply and demand issues. And the impact of passive investors on the oil market may be more subtle—and helpful—than Senators think. An index-tracker typically buys, say, a futures contract three months out, sells it as it approaches maturity, and then reinvests in another 3 month contract. Rolling this way earns a profit when the forward curve slopes downwards ("backwardation"). All that passive money, however, has supported the price of near-dated futures contracts, resulting in an upward slope ("contango") at the near end of the curve and a general flattening. This affects spot prices indirectly. When futures enjoy a positive spread over the spot price, it can make sense to store oil now and sell it forward. In turn, those higher inventories dampen spot prices by allaying fears of immediate shortages.

Barring passive investors from the market, therefore, would help push the curve back into backwardation. Inventories would be liquidated as there is little point in storing crude in anticipation of lower prices. The eventual result? Even higher prices—perhaps $200, according to economist Philip Verleger. If active speculators also were curbed, volatility would spike as liquidity drained from the market. The irony is that by squeezing inventories and limiting the scope to manage market risk the crusade against "speculators" could increase the world's dependence on important oil producers. OPEC would surely applaud.

**Easy Target, But Not the Right One**

June 28, 2008
*The New York Times*

By Joe Nocera

So now we know: it's all the fault of those damnable speculators. They're the ones to blame as the price of oil tops $140 a barrel.

It's not our government's fault for failing to come up with a credible energy policy—that can't be it. Nor is the problem the weak dollar, or the voracious energy appetite of the Chinese, or those pesky rebels in Nigeria who are trying to blow up their country's oil pipelines. And it's certainly not the fault of you and me for driving gas-guzzling S.U.V.'s. It has to be those speculators. They are the only villains in sight.

This was "first let's kill all the speculators" week on Capitol Hill, and it was not a pretty sight. On Monday, the House Oversight and Investigations Subcommittee held an 8 hour hearing (!), the sole purpose of which was to decry "excessive speculation." "Have speculators hijacked trading on the futures exchange?" asked the Michigan Democrat Bart Stupak. His answer throughout the day—as he "grilled" an array of sympathetic academics and futures market critics—was a resounding yes.

On Tuesday, the action moved to the Senate, where the Homeland Security and Governmental Affairs Committee held its hearing. "Speculation in the food and fuel markets is not illegal," Senator *Joe Lieberman* of Connecticut conceded, "but that does not mean it is not very hurtful." He continued: "They are artificially inflating the price of food and oil and causing real suffering for millions and millions of people and businesses."

There were yet more hearings on Wednesday, and by Thursday evening, the House had passed, by a wide margin, a bill calling on the *Commodity Futures Trading Commission* to curtail "excessive speculation." Indeed, the C.F.T.C. spent the week being raked over the coals for allowing all this rampant speculation to take place. On Monday afternoon, for instance, Representative John Dingell of Michigan took unseemly glee in going after Walter L. Lukken, the agency's Chairman.

Jabbing his pencil at Mr. Lukken, Mr. Dingell described the founding of the agency as an effort to prevent farmers and consumers from being "screwed" by "those folks in the futures markets."

"Now," he said, "we find that those good-hearted folks in the futures market have figured out how not just to screw the farmers and the consumers in the city, but they figured out how to screw the farmers and the consumers in the city on a whole new product—oil." As Mr. Dingell sneered triumphantly, Mr. Lukken seemed to shrivel in his seat.

Yes, it was wonderful theater, and great blood sport. And it had absolutely nothing to do with the price of oil.

It's not just Congressmen who are railing about speculators, of course. As oil prices have doubled in the last year, I've gotten e-mail messages from readers decrying speculators, who, many believe, are manipulating the futures market. More than once this week, legislators used that same word their constituents were using: "manipulation."

So let's take a closer look at what the speculators' critics are saying. First, despite the loose use of the word "manipulation," that is really not what is being alleged here, at least not in the classic sense. Remember how the Hunts tried to corner the silver market? They bought up silver and took it off the market, thereby creating an artificial shortage. I suppose *OPEC* could do something like that—one could even argue that OPEC does that already—but no mere speculator could.

I can already hear your rejoinder: what about *Enron* and its famous manipulation of energy prices in California? But remember, Enron was manipulating electricity prices, not oil, which was possible mainly because electricity can't be stored. By getting power plants to shut down for hours at a time, Enron was able to create artificial shortages and jack up the price.

Instead, the critics' thesis is that speculators are creating an energy bubble the same way investors created the Internet bubble. As speculative bets on energy have grown drastically in recent years, the sheer amount of money being thrown at energy futures is making those bets a self-fulfilling prophecy. All that money, in other words, pushes prices higher than they would go if the market simply consisted of the actual buyers and sellers of oil.

In addition, because of something called the "London loophole" and the "Enron loophole," which allow speculators to use unregulated exchanges, they can evade the limits of the *New York Mercantile Exchange*, as well as C.F.T.C. scrutiny.

The leading proponent of this theory is a portfolio manager based in the Virgin Islands named Michael W. Masters. When I caught up with him on Thursday afternoon, after his week of testimony, he said that the problem was that institutional investors had stopped seeing energy as a commodity the world relies on and instead

saw it as an "asset class" for their portfolios. "I am opposed to thinking about commodities as an asset class," he said.

Several years ago, he continued, he began to notice that increasing cash flows were moving into commodities index funds. This was, he said, "long-only money"—meaning that it was a pure bet that prices would go up. By now, he told me, there is $240 billion in commodity index funds, up from $13 billion 5 years ago. As he also noted in his testimony before Congress, "the prices of the 25 commodities that compose these indices have risen by an average of 183 percent in those 5 years!" He claims that energy prices will fall by 50 percent if the speculators can only be driven out of the futures market.

There are so many holes in this argument I scarcely know where to start. The C.F.T.C. says that some $5 trillion worth of futures and options transaction trades take place every day; can an influx of $240 billion, spread over 5 years, really propel prices upward to the extent that he and others claim? Then there's the fact that the commodities markets don't work like equity markets, where a small amount of trading can lift every share of a company's stock. In commodities trading, every contract has a buyer and a seller, meaning that for every bet that prices are going up, somebody else is betting they are going down. Why doesn't that short interest depress prices?

And what about all those commodities, like coal or barley or sulfur, that don't trade on any futures market but have risen as fast as or faster than oil? Or how about the recent decline in cash flows into many commodity funds—why have prices kept going up if the money has stopped pouring into those funds? My speculator friends tell me that in the last 2 weeks, trading volumes have been cut in half. Indeed, what I hear is that much of the speculative money that remains in the market is betting against higher oil prices.

As for the London and Enron loopholes, I can pretty much guarantee they will be closed soon. There are some eight bills aimed at curbing speculation, and virtually every one of them calls for an end to the loopholes. That is probably a good thing—but I'd lay odds the price will not drop as a result. The loopholes are not the reason prices are going up.

In fact, I'd be willing to go a step further. Even if you eliminated speculation entirely, the price of oil wouldn't fall. Thankfully, no one is proposing to go that far (though Senator Lieberman was toying with the idea), because even Members of Congress understand that futures markets serve a crucial purpose. They help companies hedge their oil prices, and they help energy companies manage their risk, for starters.

The energy speculators I spoke to say that Congress has it exactly backward: the futures market is actually taking its cues from the physical market, where the buyers and sellers of oil do their business. Last week, the Saudis promised to produce an extra 200,000 barrels a day. But it is pricing that oil so high that oil companies are balking at paying for it. The Saudis didn't arrive at their price by looking to the futures market—but if they get that price, it will certainly affect the futures market.

Both speculators and oilmen say that supply and demand is the real culprit. "Our supply is pathetic," said Gary Ross, the chief executive of the PIRA Energy Group, and a well-known energy consultant. "Look at the data," he continued. "The world economy is growing by 3.9 percent a year. World oil demand should grow by 2.3 percent just to keep pace. That's an extra two million barrels a day. We don't have it! It's obvious."

I also think there is something else at play. After years of ignoring the rather obvious fact that oil is a finite resource, the world has suddenly become acutely aware of that reality. Everyone in the oil markets is attuned to every little twitch that has the potential to damp supply or increase demand. That's why, for instance, when Libya announced on Thursday that it might cut oil production, oil jumped more than $5. Meanwhile, when Brazil discovers a huge new oil field, the market shrugs. That is not speculation at work—it's market psychology. There's a big difference. If there is indeed a bubble, that's what is causing it.

"Speculators have always been an easy target," said Leo Melamed, the man who founded the futures markets. As *Ron Chernow,* the great business historian put it, "At times in history when you have vast and impersonal forces wreaking havoc in markets, there is always a temptation to villainize someone." Centuries ago, it was Shylock; now it's the speculator and the short-seller.

In his book "The House of Morgan," Mr. Chernow has a description of Herbert Hoover, "moody and isolated," convinced that short-sellers were behind the market's horrendous downturn in 1929. "He came to believe in a Democratic conspiracy to drive down stocks by selling them short," Mr. Chernow writes, adding that Hoover

"began to compile lists of people in the bear cabal and even claimed to know they met every Sunday afternoon to plot the week's destruction!"

I wonder whether Mr. Dingell has heard about them.

**Who's Behind High Prices**

*The Washington Post*
By Robert J. Samuelson
Tuesday, July 1, 2008; Page A11

Tired of high gasoline prices and rising food costs? Well, here's a solution. Let's shoot the speculators. A chorus of politicians, including John McCain and Barack Obama, blames these financial slimeballs for piling into commodities markets and pushing prices to artificial and unconscionable levels. Gosh, if only it were that simple. Speculator-bashing is another exercise in scapegoating and grandstanding. Leading politicians either don't understand what's happening or don't want to acknowledge their own complicity.

Granted, raw materials prices have exploded across the board. From 2002 to 2007, oil rose 177 percent, corn 70 percent, copper 360 percent and aluminum 95 percent. But that's just the point. Did "speculators" *really* cause all those increases? If so, why did some prices go up more than others? And what about steel? It rose 117 percent—and has increased further in 2008—even though it isn't traded on commodities futures markets.

A better explanation is basic supply and demand. Despite the U.S. slowdown, the world economy has boomed. Since 2002, annual growth has averaged 4.6 percent, the highest sustained rate since the 1960s, says economist Michael Mussa of the Peterson Institute. By their nature, raw materials (food, energy, minerals) sustain the broader economy. They're not just frills. When unexpectedly high demand strains existing production, prices rise sharply as buyers scramble for scarce supplies. That's what happened.

"No one foresaw that China would grow at a ten percent annual rate for over a decade. Commodity producers just didn't invest enough," says analyst Joel Crane of Deutsche Bank. In industry after industry, global buying has bumped up against production limits. In 1999, surplus world oil capacity totaled five million barrels a day (mbd) on global consumption of 76 mbd, reckons the U.S. Energy Information Administration. Now, the surplus is about two million barrels per day—and much of that is high-sulfur oil not prized by refiners—on consumption of 86 mbd.

Or take nonferrous metals, such as copper and aluminum. "You had a long period of under-investment in these industries," says economist John Mothersole of Global Insight. For some metals, the collapse of the Soviet Union threw added production—previously destined for tanks, planes and ships—onto world markets. Prices plunged as surpluses grew. But Mothersole says "the accelerating growth in India and China eliminated the overhang." China now accounts for up to 80 percent of the world's annual increased use of some metals.

Commodity price increases vary because markets vary. Rice isn't zinc. No surprise. But "speculators" played little role in these price run-ups. Who are these offensive souls? Well, they often don't fit the stereotype of sleazy high rollers: Many manage pension funds or university and foundation endowments.

Their trading might drive up prices if they were investing in stocks or real estate. But commodity investing is different. Investors generally don't buy the physical goods, whether oil or corn. Instead, they trade "futures contracts," which are bets on what prices will be in, say, 6 months. For every trader betting on higher prices, another is betting on lower prices. These trades are matched. In the stock market, all investors (buyers and sellers) can profit in a rising market, and all can lose in a falling market. In futures markets, one trader's gain is another's loss.

Futures contracts enable commercial consumers and producers of commodities to hedge. Airlines can lock in fuel prices by buying oil futures; farmers can lock in selling prices for their grain by selling grain futures. The markets work because numerous financial players—"speculators" in it for the money—can take the other side of hedgers' trades. But the frantic trading doesn't directly affect the physical supplies of raw materials. In theory, high futures prices might reduce physical supplies by inspiring hoarding. But that's not happening now. Inventories are modest. World wheat stocks, compared with consumption, are near historic lows.

Recently, the giant mining company Rio Tinto disclosed an average 85 percent price increase in iron ore for its Chinese customers. That affirmed that physical supply and demand—not financial shenanigans—is setting prices: Iron ore isn't traded on futures markets. The crucial question is whether these price increases will continue or ease as demand abates and investments in new capacity expand supply. Prices for some commodities (lead, nickel) have receded. Could oil be next?

Politicians promise to tighten regulation of futures markets, but futures markets aren't the main problem. Scarcities are. Government subsidies for corn-based ethanol have increased food prices by diverting more grain into biofuels. A third of this year's U.S. corn crop could go to ethanol. Restrictions on oil drilling in the United States have limited global production and put upward pressure on prices. If politicians wish to point fingers of blame, they should start with themselves.

# SPAN: The First 20 Years

*By David Adam*

**Happy anniversary! With little fanfare the CME Group is celebrating the 20th anniversary of the launch of Standard Portfolio Analysis of Risk, or SPAN—a methodology for evaluating risk and calculating margin requirements that revolutionized futures and options risk management when it was introduced and today serves as an industry standard around the world.**

Over 20 years ago, Rick Kilcollin and David Emanuel, chief economist and senior economist in the CME research department, respectively, at the time, saw the need to apply the same risk management approach to options that CME had successfully applied to futures. Options trading was growing rapidly, but methods for calculating margin requirements in use at the time did not do a good job of accurately capturing the true risk for combined portfolios of futures and options. That was a problem either way. If requirements were too low, they wouldn't protect the clearing organization and the clearing firm from risk of default. If too high, they would use capital inefficiently. Kilcollin and Emanuel proposed a true risk-based method for evaluating a portfolio's performance bond requirements. They had captured the concept, but their proposal was too complicated for the bookkeeping services in the mid-1980s.

Jerry Roberts, a CME economist, was tasked with strengthening and simplifying this risk-based method and making it acceptable to the industry's back offices. He divided the process into two parts: the option pricing calculations with their complex math, and the portfolio risk calculations with their basic arithmetic. The exchange or clearing organization would do the option pricing, and package results into a file called the SPAN risk parameter file, also often referred to simply as the SPAN file. The SPAN file would be freely distributed to clearing firms and the broader community of market participants. The clearing firms and their bookkeeping services could then apply the data in the SPAN file to the portfolio of positions held in individual accounts using simpler programs and more understandable processes. This innovation gave the system the flexibility it needed to deliver powerful risk management in a customer-friendly package.

CME then created a cross-functional team to build the new system and sell the industry on its merits. Kate Meyer, a key member of the Clearing Division management team, led the charge, and Ed Gogol, software developer, Clearing Division, developed the original version of the PC program that proved critical to success. CME rolled SPAN out for calculating performance bond requirements for CME clearing firms on Dec. 16, 1988. "It was a big job," recalls Gogol,

now managing director, clearing solutions, "and truly an example of teamwork between design, development, and operations. And if we hadn't listened to our customers and incorporated their feedback, we would have failed." Roberts agrees: "The industry accepted the concept, but they loved the responsiveness and customer support."

"When we first developed SPAN, it was for our own use," says Gogol. "But other markets had the same need, so it was natural for us to provide SPAN to other exchanges and clearing organizations." Working through the Joint Audit Committee, SPAN was adopted over the next few years by all North American futures markets. From there, SPAN spread to global financial capitals including London, Paris, Tokyo, Osaka, Singapore, Hong Kong, Sydney and many others. Over the years, SPAN has been adopted by more than 50 exchanges and clearing organizations.

CME points to several reasons for SPAN's widespread adoption: *(1)* the methodology itself, in particular its power and flexibility, *(2)* the ease with which SPAN could be implemented, *(3)* the benefits of standardization, and *(4)* the software for SPAN which CME has made available.

### The SPAN Methodology

Like all methodologies that are part of the of the Value-at-Risk (VAR) family, it's not really meaningful to ask whether margin requirements calculated by SPAN are higher or lower than those calculated by other methods. The results provided by SPAN are crucially affected by the inputs provided to the methodology, and in particular the desired degree of risk coverage. The most important point about SPAN is that, given a particular desired degree of risk coverage, it will do a better job of targeting the margin requirement to the actual risk of the portfolio than methodologies which are not portfolio-approach based and risk-based.

For example, CME typically sets SPAN inputs to cover the maximum likely one-day loss to at least a 95% confidence level, and in most cases to a 99% confidence level. Other markets might set the inputs to cover risk to a different confidence level, and some SPAN users seek to cover the maximum loss over a two-day or a three-day "look-ahead" period.

Besides the number of days ahead for which risk is being evaluated, the key inputs to SPAN, for each product, are parameters which specify how much the price might change over the desired period, and how much the volatility of that price might vary. For options, these parameters are specified for the underlying instrument. Then, using particular combinations of changes in underlying price and volatility of underlying price, SPAN performs a series of simulations to determine how each particular tradeable instrument might gain or lose value over a specified time in the future. The set of scenarios which is evaluated for each instrument is called the risk scenario set, and the results of the simulations—a series of simple monetary gains and losses—are called the risk arrays.

The risk arrays for every contract are packaged into the daily SPAN risk parameter file, which can be thought of as: a machine-readable database of eligible contracts; their daily settlement prices and other product information; SPAN risk arrays; and all other parameters needed by SPAN to calculate margin requirements. Produced at least once per day by every exchange or clearing organization using SPAN, the SPAN file is then distributed freely to market participants.

The data contained in the SPAN file is then applied to particular portfolios—for example, a daily calculation for each customer account by a clearing firm. The portfolio is divided into parts, called "combined commodities", each of which contains all of the instruments related to the same ultimate underlying—for example, all futures and options related to the S&P 500 index would comprise a single combined commodity. For each combined commodity, the following steps are then performed:

- Evaluating the scan risk, in which the data contained in the risk arrays is applied to the individual positions, to determine the maximum likely loss for that particular group of positions;
- Evaluating the calendar spread risk, which tailors additional charges to particular patterns of positions which may exist across particular contract months within the product;
- Evaluating the delivery risk, which recognizes special risks which may be associated with positions in physically-deliverable

## STANS: OCC's Model for Calculating Margin Requirements

In 1986, The Options Clearing Corporation developed and distributed Theoretical Intermarket Margining System, the first portfolio margin system used at a clearinghouse. TIMS, an algorithm for calculating portfolio margins and facilitating risk management, addressed shortcomings of the strategy-based method by determining the maximum loss associated with an entire portfolio of positions given a percentage move in the underlying assets. TIMS is widely used today by derivative exchanges and clearing houses for calculating risk-based haircuts and customer portfolio margins.

More recently, the OCC developed a proprietary risk margining system based on a more modern approach to measuring risk. This new approach, which requires more sophisticated statistical methods, more complex calculations, and greater computing power than TIMS, addresses certain shortcomings of the TIMS model, particularly with respect to correlations in price movements and the modeling of extreme events. Implemented in August 2006, System for Theoretical Analysis and Numerical Simulations (STANS) generates a set of 10,000 hypothetical market scenarios that incorporate information extracted from the historical behavior of each individual security as well as its relationship to the behavior of other securities. Scenarios are generated for more than 7,000 risk factors, including a broad range of individual equities, exchange-traded funds, stock indices, currencies and commodity products.

Although the OCC continues to use TIMS for several risk management functions, it relies on STANS for the critically important purpose of assessing clearing member margin requirements. According to the OCC, the STANS model provides margin calculations that are more precise, more realistic, and more consistent across portfolios, which should improve the financial stability of the derivatives markets and produce capital efficiencies beneficial to investors.

The OCC is the world's largest equity derivatives clearing organization. Last year the OCC cleared 2.872 billion options and futures contracts and handled $1.3 trillion in option premiums. Participant exchanges include: American Stock Exchange, Boston Options Exchange, Chicago Board Options Exchange, International Securities Exchange, NYSE Arca Options, and Philadelphia Stock Exchange. The OCC also serves other markets, including those trading commodity futures, commodity options, and security futures, such as CBOE Futures Exchange, OneChicago and Philadelphia Board of Trade.—*David Adam*

products as they approach or go into their delivery process; and

- Evaluating the intercommodity spread credit, which recognizes reductions in risk associated with offsetting positions in different products.

The sum of these risk components becomes the SPAN risk requirement for the combined commodity, except that the value is floored at the short option minimum amount, a special process which recognizes risk for deep out-of-the-money short option positions. The SPAN risk requirements for the different combined commodities are then converted to a common currency and summed to yield the total requirement for the portfolio.

As a methodology, SPAN is applicable to a very wide spectrum of derivative and physical product types. Over the years, SPAN has been extended, generalized, and made very powerful. "We're now on the fourth generation of the SPAN methodology—we call it SPAN 4," says Gogol, "and we're working on SPAN 5."

SPAN is also particularly well-suited for use in clearing linkages which can reduce margin requirements, such as inter-exchange spreading or formal cross-margin agreements. CME has cross-margin agreements in place with the Options Clearing Corporation, Nymex Clearing, LCH.Clearnet and the Fixed Income Clearing Corp. Another SPAN feature worthy of special mention is the ability to recognize the higher risk of markets where positions are concentrated in a relatively small number of market participants—something which CME does as part of every daily settlement cycle.

### Ease of Adoption, and SPAN Software

Besides its characteristics as a methodology, two factors driving the worldwide adoption of SPAN have been the ease with which an exchange or clearing organization can implement it, and the software which CME makes available for SPAN.

As a machine-readable database of product information, settlement prices, and margin rates and rules, the daily SPAN file produced by each SPAN-using exchange and clearing

## Scanning a Sample Portfolio

Here is an example of how the Span methodology works in practice. The following 16 scenarios are based on a simple portfolio of two related positions: one long June 04 Euro FX futures contract and one short June 04 call option on the June 04 Euro FX futures with a 1.150 strike. Assume that the settlement price on the futures contract was 1.1960, that the futures price scan range was $2400, equivalent to 192 points, and that the volatility scan range was 1%. Based on these inputs, the system then evaluates the "scan risk," which represents the maximum likely loss for this portfolio under various market conditions.

| # | One Long June 04 EuroFX | One Short June on June 04 1.150 Call EuroFX Option | Portfolio | Scenario Description |
|---|---|---|---|---|
| 1 | $0 | - $130 | - $130 | Price unchanged; Volatility up the Scan Range |
| 2 | $0 | $155 | $155 | Price unchanged; Volatility down the Scan Range |
| 3 | $800 | - $785 | $15 | Price up 1/3 the Price Scan Range; Volatility up the Scan Range |
| 4 | $800 | - $531 | $269 | Price up 1/3 the Price Scan Range; Volatility down the Scan Range |
| 5 | - $800 | $500 | - $300 | Price down 1/3 the Price Scan Range; Volatility up the Scan Range |
| 6 | - $800 | $815 | $15 | Price down 1/3 the Price Scan Range; Volatility down the Scan Range |
| 7 | $1600 | - $1463 | $137 | Price up 2/3 the Price Scan Range; Volatility up the Scan Range |
| 8 | $1600 | - $1240 | $360 | Price up 2/3 the Price Scan Range; Volatility down the Scan Range |
| 9 | - $1600 | $1102 | - $498 | Price down 2/3 the Price Scan Range; Volatility up the Scan Range |
| 10 | - $1600 | $1446 | - $154 | Price down 2/3 the Price Scan Range; Volatility down the Scan Range |
| 11 | $2400 | - $2160 | $240 | Price up 3/3 the Price Scan Range; Volatility up the Scan Range |
| 12 | $2400 | - $1967 | $433 | Price up 3/3 the Price Scan Range; Volatility down the Scan Range |
| 13 | - $2400 | $1674 | - $726 | Price down 3/3 the the Price Scan Range; Volatility up the Scan Range |
| 14 | - $2400 | $2043 | - $357 | Price down 3/3 the Price Scan Range; Volatility down the Scan Range |
| 15 | $2304 | - $2112 | $192 | Price up extreme (3 times the Price Scan Range) – Cover 32% of loss |
| 16 | - $2304 | $1466 | - $838 | Price down extreme (3 times the Price Scan Range) – Cover 32% of loss |

In the sample portfolio above, in scenario 8, the gain on one long June 04 EC futures position offsets the loss of one short EC June/June 04 1.150 call option position, incurring a gain of $360.

In scenario 16, the portfolio would incur a loss of $838 over the next trading day, which is 32% of the resulting loss if the price of the underlying future decreases by three times the price scan range.

After SPAN has scanned the different scenarios of underlying market price and volatility changes, it selects the largest loss among these observations. This "largest reasonable loss" is the scan risk charge. In this example, the largest loss across all 16 scenarios is a result of scenario 16, a loss of $838.

organization becomes an invaluable tool for market participants. As the developer of the SPAN methodology, CME makes available to the public, without charge, daily SPAN files for most SPAN-using exchanges and clearing organization; in fact, for any SPAN-using exchange or clearing organization that cares to transmit their files to CME. "People really look to these files for risk management and other purposes," says Gogol. "We get calls from around the world when somebody's SPAN file is late getting to our FTP site."

CME makes available three software products for SPAN: PC-SPAN, SPAN Risk Manager, and SPAN Risk Manager Clearing, each of which builds upon the capabilities of the others:

- PC-SPAN loads SPAN risk parameter files, allows users to define portfolios, and calculate SPAN performance bond requirements. Users can then produce a wide variety of reports, and/or export results to other processes. The most typical use for PC-SPAN is by a market participant wishing to verify the performance bond requirements their clearing firm is charging, or to evaluate what the SPAN requirement for a particular portfolio will be. Auditors and regulators also make wide use of the program.
- SPAN Risk Manager provides generalized risk management capabilities. A variety of option pricing calculations can be performed, portfolio "greeks" can be evaluated, and what-if scenarios can be defined and applied.
- SPAN Risk Manager Clearing provides a turn-key implementation of SPAN for use by exchanges and clearing organizations.

All three products run in the Microsoft environment, either on workstations or servers, and can be operated in any of three modes: *(1)* a point-and-click graphical user interface; *(2)* using a script language, which makes it easy to automate routine processing tasks; and *(3)* using the "real-time component interface", which allows the SPAN software to be driven in a high-speed manner suitable for real-time risk-based pre-execution credit controls.

"This is the same software we use ourselves," says Gogol, "both for calculating performance bond requirements for our clearing firms, and for a wide variety of associated risk management processes such as stress testing."

## The Future of SPAN

CME says that it is working on SPAN 5—the next generation of the SPAN methodology. "In 1988, SPAN represented a balance between theoretical perfection, on the one hand, and keeping things simple to program and easy to understand on the other," says Gogol. "But today, computers are many times more powerful. And the complexity of the derivatives that we have to process keeps increasing."

The next generation of SPAN is expected to include increasing the sophistication of recognizing risk offsets between related products, incorporating the effect of volatility changes on a more dynamic basis, and adding special processing for more complex options, such as digitals and barriers. CME is not committing to a detailed timeframe for SPAN 5. "We're acutely sensitive to the magnitude of the investment that clearing firms and software providers have made in building and enhancing SPAN," says Gogol. "We're committed to maintaining SPAN's high degree of customer friendliness and ease of implementation." ■

**David Adam** is a consultant and freelance writer based in Chicago with 20 years experience in commodity futures and options clearing/settlement operations and client services with multiple market users and providers including exchanges, institutional futures brokers, and proprietary trading groups.

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

**STATEMENT OF KENDELL KEITH, PRESIDENT, NATIONAL GRAIN AND FEED ASSOCIATION, WASHINGTON, D.C.**

Mr. KEITH. Good morning, Mr. Chairman and Members of the Committee. I am Kendell Keith of the National Grain and Feed Association. We appreciate the opportunity to participate here today.

First, I would like to comment on financial liquidity in our industry. The very rapidly rising commodity prices have created an unprecedented financial squeeze in our industry. While the banking industry has been very supportive, banks do have limits on long capacity and in some cases have restricted ownership positions for our companies out of necessity. This changing capital need has led to a major pullback in our industry on offering forward grain contracting, which is very unfortunate both for our industry, companies, and the farmers that we serve.

We are at work on solutions to this issue. One idea that has emerged that could help is one that has been developed by the Merchants Exchange of St. Louis. It would permit a financial swap to be sold by a party holding a long position to a short hedger that in essence would fund the margin calls as the market goes up. This has yet to be proven, but in the next few weeks there is going to be a pilot for that project and we think that it does hold some promise.

Next, I would like to comment on market performance. There is no question that there has been less consistent convergence in cash and futures and the commodity markets that we participate in than we have experienced in the past. This has led to more of a disconnect between cash and futures, and the futures price is a less reliable measure of the true underlying value of commodities in our business. The situation has led to much more volatility in basis levels and partially contributes to a substantial widening in basis in particular for wheat.

How can we improve market performance? Well, we are working with the CME Group and others on evaluating storage rate levels that might enhance the market's ability to converge at expiration and other concepts, such as index markets, making more delivery points available and compelling the taker of delivery to load out. All of these issues are being reviewed.

While we are concerned about market performance, I want to assure this Committee that NGFA continues to receive outstanding cooperation from both exchanges and the CFTC in working as quickly as possible toward possible solutions.

Regarding the setting of margins, we hold the philosophy that the exchanges and the clearing corporations are still in the best position to establish and assess risk and establish margins in volatile conditions. As markets change daily, adjustments in margins are always necessary, and the exchanges remain in the best position to evaluate those needed changes.

Finally, we have some comments and recommendations regarding futures market transparency that we would like this Committee to consider.

First, we recommend that swaps dealers, index and pension funds, exchange traded funds, and issuers of exchange traded notes and other similar nontraditional participants be required to report to CFTC to justify their futures market positions. In essence, we think this would level the playing field. It would cause these traders that are not considered to be speculators and therefore not restricted by speculator limits to have the same reporting requirements as large commercial hedgers in our industry who have to report cash positions on a monthly basis. Though nontraditional participants don't have cash positions *per se,* we would like to see them report their analogous positions regarding which ag futures serve as a financial hedge.

Our second recommendation would increase the usefulness of the CFTC's weekly Commitment of Traders report which our industry relies on to assess who is participating in the markets. We would like to see the CFTC require the large nontraditional participants to disaggregate data so it clearly shows activity that should be reported in the index category of the COT report. Currently CFTC is unable to report some index activity because positions are being netted out prior to being reported to the Commission. We would also like to urge that the CFTC make another review of its breakout of various categories of the Commitment of Traders report to ensure the definitions of categories are clear and stated in ways that prevent large nontraditional hedgers or investors from reclassifying themselves or self-selecting categories within the reported framework. Making such reporting regular and permanent by the nontraditional hedgers we think would shed more light on speculative investment capitals, participation in ag futures and related OTC activity, and also help the CFTC basically to do its job.

Thank you for the opportunity to participate today.

[The prepared statement of Mr. Keith follows:]

PREPARED STATEMENT OF KENDELL KEITH, PRESIDENT, NATIONAL GRAIN AND FEED ASSOCIATION, WASHINGTON, D.C.

Thank you, Mr. Chairman, and Mr. Goodlatte, for calling today's hearing to examine activity in agricultural futures markets. The National Grain and Feed Association (NGFA) appreciates the opportunity to testify.

I am Kendell Keith, President of the NGFA. Our members include over 900 companies, including grain elevators, feed manufacturers, oilseed processors, flour mills, biofuels producers and marketers and many other related commercial businesses. We estimate that these member firms operate more than 6,000 facilities nationwide. 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 efficient and well-functioning futures markets for price discovery and risk management, and to help them provide marketing options for their producer customers.

**Financial Liquidity Crisis**

On May 15, the NGFA testified before the Subcommittee on General Farm Commodities and Risk Management that grain elevators were feeling financial stresses due to historically large borrowing to finance grain inventory and margins necessary to maintain hedges. Today, spiraling commodity futures prices have brought additional challenges to our industry. If grain and oilseed prices continue to advance, we will experience a further crunch on liquidity among grain hedgers that could force companies to reduce cash grain-buying activities and could ultimately cause additional company consolidation.

Typically, when producers want to market their crops, one of the primary tools they utilize is forward cash contracts written with their local elevator. When the ele-

vator contracts with the producer to purchase cash grain—often for delivery many months later—the elevator hedges its cash position by selling futures on an exchange like the Chicago Board of Trade, the Kansas City Board of Trade, or the Minneapolis Grain Exchange. The elevator performs a valuable service for the producer by assuming price risk on his behalf.

The problem this year is that futures prices for agricultural commodities have reached record levels, spurred upward by historically tight supplies, flooding in the Midwest, and an influx of speculative investment capital. An elevator that forward contracted with a producer last year and sold futures on-exchange—a tried-and-true, prudent risk management strategy—now has seen futures prices advance to record levels. As the gap between the elevator's short futures position and the current futures price has grown, the elevator has been obligated to meet ever-growing margin requirements established by a futures exchange—margin requirements that we recognize as legitimately needed to protect the financial well-being of the exchange and its clearing corporation. Add to this the increasingly expensive financing of grain and oilseed inventories and the elevator's borrowing needs have become immense.

To illustrate the heightened *harvest borrowing needs* of a typical country elevator today, the following simulation is derived from an aggregate of the customer base of an NGFA-member firm that provides futures and option brokerage services to the agricultural industry, along with offering hedging education and merchandising risk-management services. It arrives at an "average" case that is illustrative of conditions faced by a "typical" commercial grain hedger today to *purchase inventory*—increased borrowing needs in the range of 250–300%.

Figure 1

| | A | | | B | | | C | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2006 | | | 2008 (Projected) Big Crops | | | 2008 (Projected) Small Crops | | |
| | Bushels purchased | Price | | Bushels purchased | Price | | Bushels purchased | Price | |
| **Corn** | 1,000,000 | $2.30 | $2,300,000 | 1,230,000 | $5.50 | $6,765,000 | 1,100,000 | $7.50 | $8,250,000 |
| **Soybeans** | 400,000 | $5.50 | $2,200,000 | 428,000 | $11.00 | $4,708,000 | 375,000 | $16.00 | $6,000,000 |
| **Wheat** | 150,000 | $3.50 | $525,000 | 180,000 | $7.00 | $1,260,000 | 170,000 | $8.00 | $1,360,000 |
| **Cost - Inventory** | | | **$5,025,000** | | | **$12,733,000** | | | **$15,610,000** |
| **Harvest Inventory Cost Increase** | | | | | | 253.4% | | | 311.0% |

Source: Grain Service Corporation.

To help further understand the financial stresses a "typical" elevator might face when *hedging forward purchases,* a separate but related exercise looked at a selected group of elevators for whom the actual weighted average per bushel "loss" on open 2008 crop, 2009 crop and 2010 crop hedges were $1.46 for corn, $4.47 for soybeans and $3.51 for wheat, for a total weighted average hedging loss of $2.49 per bushel (*Figure 2*). Applying those averages to several real-world elevators who buy grain from producers and hedge on-exchange shows that a "typical" country elevator's hedges could be "under water" in amounts ranging from just less than $1 million to almost $8 million, as a consequence of forward contracting with its producer-customers. (Note: these figures are not specific to any one elevator; they are illustrative in nature but believed to be indicative of actual hedging results.)

Figure 2

**Hedge Losses – '08, '09 and '10 Crops**
(Weighted average prices as of 2/29/08)

| | Elev. 1 | Elev. 2 | Elev. 3 | Elev. 4 |
|---|---|---|---|---|
| Corn | 876,000 | 751,900 | 4,015,000 | 408,800 |
| Soybeans | 1,005,750 | 581,100 | 3,799,500 | 469,350 |
| Wheat | 596,700 | | | |
| Hedging Loss | $2,478,450 | $1,333,000 | $7,814,500 | $878,150 |

1: Eastern corn belt, single-station elevator hedging 600,000 bushels corn, 225,000 bushels soybeans and 170,000 bushels soft red wheat
2: Eastern corn belt, single-station elevator hedging 515,000 bushels corn and 130,000 bushels soybeans
3: Northern corn belt, multi-station firm hedging 2.75 million bushels corn and 850,000 bushels soybeans
4: Western corn belt, single-station elevator hedging 280,000 bushels corn and 105,000 bushels soybeans

Source: Grain Service Corporation

Note that the above analysis was conducted using Feb. 29 prices. If we factor in price changes since that time (through July 3), the "average" hedger's situation has become even more dramatic, with average wheat hedge losses easing somewhat, but corn and soybean hedge losses escalating dramatically (*Figure 3*):

Figure 3

| | 2/29 per bushel loss | 7/3 per bushel loss |
|---|---|---|
| Dec. '08 corn | $5.64 | $7.77 |
| Dec. '09 corn | $5.38 | $6.97 |
| | | |
| Nov. '08 beans | $14.26 | $16.31 |
| Nov. '09 beans | $13.71 | $15.54 |
| | | |
| July '08 wheat | $10.00 | $8.73 |
| July '09 wheat | $9.70 | $9.49 |

Source: Grain Service Corp.

Looking at these numbers, it is not difficult to understand that one consequence of this financial liquidity squeeze is that many elevators have been forced to restrict or even eliminate forward contracting with producers. This is a very unfortunate situation given that many producers rely exclusively on cash forward contracts to manage price risks. Many elevators are unable to access enough funding to finance hedges on new-crop forward purchases, and many view the risks of forward purchases in an increasingly volatile marketplace as being unmanageable. This is a significant shift in the way our industry does business, and has frustrated producers who would like to lock in attractive prices for this fall's harvest.

We believe the lenders who do business with our industry have done a good job to date in responding to borrowing needs that are several multiples of normal, expected levels. However, we are hearing from our member companies that some lenders are at or near their lending limits, while other lenders may have access to sufficient funds but are reaching the upper bounds of the business risk they are willing to assume. In our current tight stocks situation, additional price advances likely would result in elevators being unable to access sufficient funds for operations and for margining. In a worst case situation, another weather event or other supply disruption this summer could drastically deepen the financial difficulties for our industry, cause further consolidation, and further reduce cash grain bids available to farmers.

The NGFA is not requesting any specific action by this Committee or by Congress at this time to respond to the financial liquidity crisis our industry is facing. However, we do want the Committee to be aware of the situation, and we would like to keep you apprised as we move into the critically important summer growing season.

I would add one final observation regarding our industry's financial liquidity crisis and escalating commodity and food prices. At its core, the problem goes back to supply and demand fundamentals. Today, U.S. grain and oilseed production is having trouble keeping up with growing demand driven by increasing consumption in developing countries like China and India; the continuing growth of the U.S. biofuels sector; and other factors. Grain stocks have declined in 6 of the last 7 years. We have seen market disruptions this year due to weather problems in the Midwest. The current very tight supply/demand situation is bound to result in higher commodity prices that will be attractive to non-traditional market participants. One much-needed response, for which the NGFA has called for many months, is for Secretary of Agriculture Ed Schafer to announce a penalty-free early-out from Conservation Reserve Program contracts on cropland that can be farmed in an environmentally sustainable way.

**Futures Market Transparency**

The NGFA's legislative priority with regard to futures markets is to enhance transparency. Knowing who is participating in agricultural futures markets and being able to gauge the impact of participants is critically important to grain hedgers. The CFTC made an important advance in this respect early last year when it implemented a new "Index" category in the weekly Commitments of Traders report. However, with the continuing influx of speculative investment capital into agricultural futures markets, and the advent of new market participants like exchange-traded funds (ETFs) and exchange-traded notes (ETNs) we believe additional reporting and transparency is needed.

The challenge is identifying all market participants that should be subject to enhanced reporting and, in turn, that should be reported on by CFTC. Index funds, pension funds, swaps dealers, ETFs, and ETNs all participate primarily on the long side of futures markets, and we believe they should be required to report to CFTC on their exchange-traded positions. However, there may be other new and developing participants who should be subject to reporting too; the challenge is how best to describe all the players correctly.

We would advise Congress against overly prescriptive approaches, as it is difficult to anticipate outcomes and reactions of market participants. It is not sufficient simply to require reporting from "passive, long-only" participants. Some of the above players may currently have short positions in futures markets; and some of them might "go short" in a few small positions just to avoid reporting requirements. In addition, as the market adjusts and likely goes into a downward price trend at some point in the future, these participants may adopt investing strategies that call for greater percentages of commodity assets in short positions. We need to look to the future and try to craft legislation that foresees these possibilities, and we look forward to working with Congress in this effort.

We also would caution against Congress attempting to legislate things like margin requirements or the share of futures positions that certain types of participants can hold in agricultural futures markets. These kinds of proposals have been made by various Members of Congress with regard to energy markets. For agricultural markets in particular, we believe the establishment of appropriate margins for various market circumstances is best left to the exchanges and their clearing corporations, which are in the optimal position to make determinations about what is needed to safeguard their financial integrity. We would also fear the "law of unintended consequences" might apply in this case, and that attempts to regulate "speculators" could overreach and affect participants who are very important to providing liquidity in agricultural futures markets.

**Futures Market Performance Issues**

The NGFA's final major concern revolves around the performance of U.S. agricultural futures markets. It is of paramount importance that futures exchanges continue to serve their long-established roles of price discovery and risk management for traditional users like grain hedgers. We are deeply concerned that agricultural futures markets are not satisfactorily performing those functions today.

In our May 15 testimony to the Subcommittee, we submitted evidence that cash and futures convergence in grain and oilseed contracts, a bedrock principle for the hedging efficiency of futures markets, has been compromised in recent months. That remains true today. 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, including higher fuel costs; (2) demand for storage created by biofuels growth; and (3) the futures market running ahead of cash values due to the infusion of speculative investment capital.

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 physical commodities, but rapid advances in futures price levels have widened basis to levels not historically expected.

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 the participation of large amounts of speculative investment capital like index and pension funds into agricultural futures markets is causing disruption in markets and resulting in futures prices that no longer reflect true supply/demand fundamentals.

In today's marketplace, it is critically important that all market participants—including farmers and grain elevators—be able to see and understand the impacts of non-traditional participants like index funds and others mentioned above. With supplies tight, demand high and volatility increasing, proper identification and reporting of speculative investment capital in agricultural futures markets should be a priority.

Thank you again for the opportunity to participate in today's hearing. I would be happy to respond to any questions, and to assist this Committee in development of any legislation that may move forward.

The CHAIRMAN. Thank you, Mr. Keith.

Mr. Johnston.

## STATEMENT OF JOHN L. JOHNSTON, INDEPENDENT TRADER, IB AND PRECIOUS METALS AND ENERGY CONSULTANT, MORRISTOWN, NJ

Mr. JOHNSTON. Good morning. I am John Johnston. I am a trader. I would say there are very few days in the last 20 years where I haven't had a crude position. And I am going to speak like a trader.

I believe the passive long investor through the use of commodity index derivatives has unwittingly cornered the WTI light sweet crude oil market.

The NYMEX futures are not oil. They are a 17th century financial creation whose use has been, until recently, to help a small community of producers, consumers, trading brokers or exchange locals and speculators manage their price risks. All futures have historically been limited by their own supply and demand rules. If a trader is short in NYMEX, there is no substitute. He either buys or covers the futures contracts or the trader must deliver the physical material. Since the passive investor never liquidates his position, the short must find another seller or the physical commodity to make a conforming delivery.

Note, the passive long investor does roll a transitory and equal amount periodically as the futures contract expire. But the sale is a linked part of a calendar spread. For all intents and purposes, the passive long never contributes liquidity to the futures markets.

Here is the rub. The passive long position, as reported by credible sources, is estimated to be a weighted AIG/GSCI equivalent of 1.4 million contracts of crude oil, heating oil, gasoline and gasoil of NYMEX and/or NYMEX/ICE futures. Combined, NYMEX and ICE, crude oil, heating oil, gasoil and gasoline open interest is equal to approximately 3.5 million contracts. Therefore, the passive long-only index position is equal to 40 percent of the combined long NYMEX and ICE open interests. Otherwise stated, 40 percent of the long open interest has effectively ceased to exist from the li-

quidity pool. Therefore, there are only .6 longs available for every one short.

Think of it like six girls and ten guys at a dance. This imbalance is dynamic. As the market goes down, the active number of longs gets smaller. They sell. And the number of passive longs gets larger. They buy. The relative ratio of shorts to passive longs goes up and creates a supply void. Traditional supply and demand fundamentals are subordinate to this elementary math. One contract wanted, .6 offered. As long as this architecture is in place, the market for paper barrels of WTI light sweet crude oil on the NYMEX or ICE cannot go down. The buyer is facing a chronic deficit in the daily auction supply of futures, and the resulting outcome in terms of price is certain.

What is happening in energy markets is not much different in result than an old-fashioned commodity squeeze. The passive longs own a critical percentage of the stock or supply of daily liquidity. But the cast of players and the motives driving prices are as different as the definition of each found in my opening paragraphs. It is not important why or if the motives are legal or moral. It only matters that the opposing shorts must auction and exit from their losses by paying a premium to another seller who will risk, take the former's place. But the passive long never sells. And the new short faces the same structural imbalance as the price spirals higher and higher, ever replacing one group of short sellers with another. The auction resets over and over again at higher prices, but the architecture does not change.

The remedy in my opinion; the most effective way to deal with a problem is to raise the cost of being long and derivative exposure to all commodities on all venues, futures, OTCs, ETFs and options. If the cost of being long changes, investment committees will recognize the change and adjust their allocations.

I am certain if margins and credit requirements were raised on long positions only, except consumer hedges, crude oil would fall immediately and precipitously. I do not suggest inhibiting normal daily use of futures by *bona fide* hedgers who need protection from unforeseen negative events and prices. I do suggest a deliberate clear message: The party is over.

Let's see, I only have 40 seconds left. There is no such thing as a free market. Any intervention is designed to produce a specific result whether it is the Fed lowering the funds rate or the BOJ buying Yen in the open market.

Thank you.

[The prepared statement of Mr. Johnston follows:]

PREPARED STATEMENT OF JOHN L. JOHNSTON, INDEPENDENT TRADER, IB AND PRECIOUS METALS AND ENERGY CONSULTANT, MORRISTOWN, NJ

Many years ago, when I first became a member of the NYMEX, I read a quote by Mark Twain that described a gold mine as "a hole in the ground with a liar standing next to it." I have always remembered that wise adage and whenever there is some question about money in the commodity markets I tend to keep an eye out for the hole and the liar. There is a lot of murky information in this debate about index length and there are billions of dollars at stake, so I am careful to remind myself that those things which I am not allowed to see are probably hidden for a reason. Transparency is the key to unlocking the mystery of rising energy prices, and the sooner we can see who has what position and how big it is, the sooner this episode will be a part of history.

I have been working in the commodity futures industry for 33 years and I have been a member of the COMEX and/or NYMEX for 31 years. The opinions I intend to offer on the challenges of the commodities markets are not unlike the views of a sailor discussing the challenges of the sea: there are great natural forces at work and a good deal of intuition is needed to chart a safe course.

Pundits and journalists have recently demonized 'the speculator' as the root cause of high oil prices. I would like to be clear at the outset that I do not believe speculators deserve to be blamed for the current situation. Rather, I propose the root cause of high oil prices is the Commodity Index Investor or the "Passive Long" investor. I believe the passive long investor, through the use of commodity index derivatives, has unwittingly cornered the WTI light sweet crude oil futures market. The following discussion will make a case for understanding this blameless, yet extremely dangerous condition on futures exchanges and in leveraged derivative markets.

The market activities of the passive long investor and the speculator are polar opposites. The speculator has an investment strategy that relies on responding to market conditions. He manages and assesses his risk by evaluating changing market conditions and information. He will be either long or short, without bias. Conversely, a passive long investor invests a set allocation of assets as directed by a risk Committee, following a long only investment model. It is important to note that although the portfolio may be rebalanced, or the percentage of total assets increased or decreased, this investment model is always long. In the case of the passive long investor, the commodity index investment is used to stabilize total returns to the portfolio and not to achieve them. Thus the position remains completely passive; the investor is not seeking returns or managing risk and the index length will remain in the portfolio until the entire fund is liquidated. The long-only commodity index position merely exists and requires no measure of active management or maintenance other than periodic rollovers.

There are a lot of estimates as to the size of the commodity index position held by these passive long investors. The numbers most commonly accepted are about $250 billion dollars, of which a weighted AIG/GSCI energy allocation of 48% equals about 1.4 billion barrels of crude oil, heating oil, gasoline and gas oil. If the current estimated passive long energy position were to be sold at the rate it has taken to acquire, it would add in the neighborhood of one million barrels to daily supply for −4 years. It should be noted that during the period of liquidation, the net effect of a loss of one million barrels in demand (they stop buying) and an addition of one million barrels in supply (they start selling) would mean an increase of two million daily barrels to the supply and demand equation. It does not take much imagination to estimate the effect such liquidation would have on prices. Personally, I believe the positions of the passive long investors are much larger than estimated above.

Because crude oil and crude oil products require tremendous physical resources to transport and store, the supply/demand equation is tightly balanced. Elasticity in the physical system is limited to storage, shipping, and tankage. If total world consumption is 85 million barrels per day, then the system must produce at least 85 million barrels or the marginal excess demand will become apparent in market prices spontaneously. Conversely, because the economics of the infrastructure supporting physical crude oil impose limitations on excess commercial supplies, any surfeit will become equally apparent in the board price at the futures exchanges. This is the primary function for which futures exchanges were created: to buffer price volatility caused by short term gaps in the production/consumption chain. They were never intended to provide a long term leveraged liquidity venue for an investment community abstractly allocating of hundreds of billions of dollars.

**The Problem**

Oil futures are not oil.

The core problem is in the daily auction of futures. If you have 50 futures offered and 50 futures wanted, you have a balanced auction. If you have 48 futures offered and 52 futures wanted and you have an imbalance. The discovery of a price for the futures contract in question is not found in the transaction of the 48 which are balanced; rather it is the four demanded that have yet to be satisfied by a seller that set the price. In sum, it is the marginal excess of supply or demand which defines the benchmark price in the daily auction.

NYMEX futures are not oil. They are a 17th century financial creation whose use has been, until recently, to help a small community of producers, consumers, trading brokers (or exchange locals) and speculators (as defined above) manage their price risks. All futures have historically been limited by their own supply and demand rules. If a trader is short NYMEX futures there is no substitute: either he buys or covers the futures contracts or the trader must deliver the physical material. Since

the passive investor *never* liquidates his position, the short must find another seller or the physical commodity to make a conforming delivery. Note: the passive long investor does roll a transitory and equal amount periodically as the futures contracts expire but the sale is a linked part of a calendar spread. For all intents and purposes, the passive long *never* contributes liquidity to the futures markets.

Here is the rub:

(1) The passive long position, as reported by credible sources, is estimated to be a weighted AIG/GSCI equivalent of 1.4 billion barrels of WTI light sweet crude heating oil, gasoline and gas oil or equal to 1.4 million contracts of crude oil, heating oil, gasoline and gas oil of NYMEX and/or ICE futures.

(2) Combined NYMEX and ICE crude oil, heating oil, gasoil, and gasoline open interest is equal to approximately 3.5 billion barrels or 3.5 million contracts.

(3) Therefore: the passive long only index position is equal to 40% of the total combined long NYMEX and ICE open interest. Otherwise stated 40% of the open interest has effectively ceased to exist from the liquidity pool.

(4) Therefore: there are only .60 longs are available for every 1 short.

Think of it like six girls and ten guys at a dance.

This imbalance is dynamic: as the market goes down the active number of longs gets smaller (they sell) and the number of passive longs gets larger (they buy). The relative ratio of shorts to passive longs goes up and creates a supply void. Traditional supply and demand fundamentals are subordinate to this elementary math: one contract wanted, .60 offered. As long as this architecture is in place the market for paper barrels or for WTI light sweet crude on NYMEX or ICE cannot go down. The buyer is facing a chronic deficit in the daily auction supply of futures and the resulting outcome in terms of price is certain.

(5) What is happening in energy markets is not much different in result than an old fashioned commodity squeeze. The [passive] longs own a critical percentage of the stock or supply of daily liquidity, but the cast of players and the motives driving prices are as different as the definition of each found in my opening paragraphs. It is not important why, or if the motives are legal or moral. It only matters that the opposing shorts must auction an exit from their losses by paying a premium to another seller who will [risk] take the former's place. But the passive long never sells. And the new short faces the same structural imbalance as price spirals higher and higher ever replacing one group of short sellers with another. The auction resets over and over again at higher prices but the architecture does not change.

(6) There has been a. 99% positive correlation between the NYMEX crude contract and the Goldman Sachs commodity index over the last 2 years. This means that the market prices the entire Goldman Sachs Commodity Index at nearly at par with the NYMEX crude oil contract every day It begs one to ask if the estimates of 48% of the index being allocated to energy are perhaps low.

(7) It is ironic, but there are no criminals violating laws or rules. And . . . there are no winners: the overall portfolio that the commodity index was intended to defend suffers at an exponentially greater rate with each uptick in crude prices. Higher energy prices mean lower prices for stocks and bonds.

**The Remedy**

In my opinion, the most effective way to deal with the problem is to raise the cost of being LONG in derivative exposure to commodities on all venues: futures, OTC, ETFs, and options.

If the cost of being LONG changes, investment committees will recognize the change and adjust their allocations. This can be done by raising margins on LONGS, demanding and enforcing greater transparency of OTC swap positions and reporting the same to the market.

I am certain if margins and credit requirements were raised on all LONG POSITIONS ONLY except consumer hedges, crude oil would fall immediately and precipitously. I do not suggest inhibiting the normal daily use of futures by *bona fide* hedgers who need protection from unforeseen negative events and prices. I do suggest a deliberate clear message that the party is over.

Asking to raise margins on longs only may seem prejudicial, but if margins are raised on longs and shorts equally, prices will explode. In an up market rising margins put increasing pressure on the short. Margins have traditionally been increased in rising markets to assure performance rather than influence behavior, but the crude market is a moving target and American citizens are getting hurt. I suggest the first order of business is to inhibit buyers through tighter credit and higher

margins on longs. Investment Banks, passive investors, and producers don't need to be coddled and any complaints of encroachment on free and fair markets would be disingenuous to say the least. There is no such thing as a "free market". Any intervention is designed to produce a specific result, whether it is the FED lowering the funds rate or the BOJ buying Yen in the open market.

In my opinion, the slightest hint that the Congress might be moving to deleverage energy derivatives would have a chilling effect on prices.

Finally, so much information is hidden it is impossible to be accurate unless changes are made to allow greater transparency. I would ask the banks who have been a part of the debate to stop making a case for right or wrong. I don't think anyone has a perfect answer but stubbornly insisting that only one side of the debate is correct is not the beginning of a solution. It seems reasonable that institutions who have relied on the American people for solvency in recent months might be willing to oblige the government in its efforts to understand and deal with the effects of rising energy prices rather than arguing the truth lies only with them. I would also suggest the congress and its Committees contact passive investors directly and inform them that it's possible some of their investment objectives might be doing serious damage to the nation and its citizens. I think an effort like that might be well received. Maybe we just need a time out to get a better look at things. Handicapping margins on LONGS and I mean a hard sharp increase on all long positions (including Wall Street trading desks, day traders, and producers) will create that pause and oil prices will go down and stay down for quite a while.

Allow me to thank you for the opportunity to discuss these issues and offer my opinions.

The CHAIRMAN. Thank you, Mr. Johnston.

Mr. Duffy, you are right. Several of our colleagues have put forth legislation to increase margins. So can you tell us a little bit about the process of what is their purpose? How are they determined? And do all players play by the same rules in the marketplace when it comes to margins?

Mr. DUFFY. Absolutely. When it comes to margin, just so the Committee understands, in the futures industry it is a performance-based margin unlike that in an equity market where you are buying an asset. So if you were to be buying CME stock, you would need to put up 50 percent of the margin. If you are buying a Euro, dollar, or a corn contract on a CME exchange, you are not buying anything except for price for a later date. So what the margin is put in place for is to protect the integrity of the clearinghouse on any 1 single day's loss. So from one participant to the other can be paid in cash, which we do settle twice daily. We hold several billion dollars each day and we move $6 billion back and forth from market participants.

So performance-based bond margin and futures are completely different than the equity markets of margin, if that answers your question, sir.

Mr. HOLDEN [presiding.] Thank you. Mr. Keith, as Chairman Peterson mentioned to the previous panel, we are very much concerned on this Committee about stability in the futures market for agriculture commodities. If we were to increase margins primarily because we are looking at speculation in the oil market, what would that do to the ag commodity futures market? How would that affect the players and the producers, and so forth?

Mr. KEITH. Well, I think from our perspective, if the approach is only in the energy markets, we would just be concerned about precedent. We just think it is—the margin setting authority has traditionally been with the commercial marketplace, and it is not intended to curb any types of activity necessarily. There has been a difference in speculative margins and hedge margins, and that is

understandable. But it is really up to the exchange and the people that have the money at risk, as Mr. Duffy said, it is to ensure a performance on the contract. It is not a credit transaction.

Mr. HOLDEN. I guess what I was trying to say, Mr. Keith, we understand that if—we don't want to do something just on the energy side because if there is speculation, it will move over to the commodity side. But if we did something universally——

Mr. KEITH. Yes.

Mr. HOLDEN.—would the small guy be able to have the security in the market and would he be able to play if margins were increased? The ability?

Mr. KEITH. Well, if the hedgers from our industry, in effect, are faced by artificially higher margin requirements than what the exchange thinks is necessary, then yes, it would. And this would be the worst time ever to increase margins artificially in our industry. We are having a difficult time as it is to meet margin calls set by the exchange on the basis of market risk.

Mr. HOLDEN. Thank you.

Mr. Conaway.

Mr. CONAWAY. Thank you, Mr. Chairman. Mr. Keith, just to flush that out, I am told by ag participants that given these higher prices which drive higher margin calls, that just the mere function of the price going up makes it difficult for them to be able to use the markets in ways to meet their price risk. Is that sort of the mechanics of what happens? The price goes up, the margin requirement goes up?

Mr. KEITH. For the most part, our industry is long on cash and short on the board and the board of trade. And yes, when the prices go up, you have to set up margins to cover.

Mr. CONAWAY. Thank you. We are hearing an awful lot about excess speculation in the oil markets driving the prices up. But we have seen dramatic increases in grain and other ag commodities. Where is the hue and cry to eliminate the excess speculation there?

Mr. KEITH. Well, we think that—based on my testimony, we think that we have to measure the participants in the marketplace better than what we have to date to understand what is going on.

Mr. CONAWAY. You are talking about the ag markets?

Mr. KEITH. Yes. Until we do that, we don't really think we can make a lot of judgments. But if you ask the majority of my membership, they would probably agree that the new players in the marketplace have had some effect on prices. In essence, though, we think if we solve our convergence issues in those markets, then ultimately cash and futures have to go back to tracking each other better than they are today. And that would solve—if there is excess speculation, that is a solution to it.

Mr. CONAWAY. But don't we see that convergence in the oil markets now? There is not a divergence in the oil market, right?

Mr. KEITH. I am not an expert on oil markets. But we are having difficulty in terms of consistency in convergence today. We get it occasionally, but it is not like it used to be. With the volatility that we have in ag markets and oil markets today, you can't expect the kind of convergence that we had when corn was $2 and varied within 25¢ for the whole season. It is just not going to happen.

Mr. CONAWAY. Thank you, sir.

Mr. Duffy, Mr. Johnston laid out some specifics and fortunately warned us that he was going to talk like a trader, so much of what he was saying I think I understood. And it is not a debate but could you give us your sense of, have these passive long folks actually cornered the market in paper barrels?

Mr. DUFFY. I guess I could put my 25 year trader hat on myself, too. I spent a lot of time on the exchange before I got into the management of the business. The passive long investor, what the gentleman was referring to, that they don't sell is absolutely erroneously wrong. They do sell. They come to expiration each and every quarterly or whenever the contract is at maturity and they sell. It is indisputable: they sell. And they then move forward with the next contract.

Now I believe Dr. Pirrong gave very strong testimony yesterday citing how futures markets work. When they come to maturity, if the commercials don't believe that that price is appropriate, they will either act on that by either making or taking delivery or liquidating their position and going on to the next month. And that is exactly what we are seeing. And I am not speaking just to the energy markets but to the ag markets also.

So I disagree with what the gentleman said. It is just wrong. In futures contracts, sir, as you all know, there is an unlimited supply for futures contract. For every new long there is a new short. So you can constantly create new participants in the marketplace. And if you have 60 percent that are not even participating, they are not affecting the market up or down. So if the market was to go down, they are not selling either. So I think they provide a very vital role to the liquidity of the marketplace. So I disagree with most of the statements.

Mr. CONAWAY. Mr. Johnston, you want to kind of flush out what your comments were?

Mr. JOHNSTON. They don't sell. They roll. That means they affect a simultaneous purchase and sale on a calendar spread. Once they entered the long, that is it. They are long. They are long forever. And that long position never goes away. When you are trading——

Mr. CONAWAY. Well, technically that contract has an expiration.

Mr. JOHNSTON. Well, it expires. But it is simultaneously translated into the next month, as everybody else is. So you have a summary amount of length and shorts, whatever the open interest is. Let's just say it is a million longs. You have a million longs, a million shorts.

Mr. CONAWAY. Sure.

Mr. JOHNSTON. The passive long is constantly acquiring a greater and greater percentage of the long side of that market. And passive means passive. It means he is unresponsive to price. It means he doesn't care if you are starving, it means he doesn't care if you are freezing. He has a mandate set by a risk committee. A year ago——

Mr. CONAWAY. Excuse me. He does not care about the price? So if the price went down, he doesn't care?

Mr. JOHNSTON. He is going to acquire the length required in order to fill his investment mandate, and he will maintain it.

Mr. CONAWAY. So he cannot lose money on those contracts?

Mr. JOHNSTON. It doesn't mean that he can't lose money. It means that he doesn't care because his investment——

Mr. CONAWAY. He doesn't care if he loses——

Mr. JOHNSTON. Not at all. The whole idea, the paradigm of passive investing is to stabilize returns, not to achieve returns. It is a noncorrelating asset class. So if stocks and bonds are going up, usually commodities are going down. That is the theory. Right now stocks and bonds are going down. Commodities are going up. So from that point of view, the paradigm is performing. But where it mixes things up in commodities is the passive long is virtually indifferent to price discovery, liquidity. He makes no contribution to that. What he does is he owns a huge stock of the daily liquidity supply and he does not contribute that ever.

Mr. CONAWAY. So squeezing additional liquidity out of the market would be helpful?

Mr. JOHNSTON. He doesn't even know he is squeezing anything. What he has done is he has made a decision in Committee. Here is a good example. Last February a lady came on TV from CalPERS and said, "We had $500 million in commodities for the last few years. It has been great. We are going to raise it sixteenfold this year and go to $7 billion." You do the math on that. GSCI website says it is 77.5 percent energy. That meant that they were going to pick a window of liquidity this year and buy 55,000 lots of energy. I know everybody is kind of grappling with, is a million big, is this small? Take it from me, a 55,000 lot buy order going into energy is massive. It is huge. And you can pick the dates. You can call CalPERS. I suggest you do that and say, hey, when did you make this announcement? And look what happened to crude oil. There was a frantic tormented demand for liquidity in crude following in the next 4 weeks.

Mr. CONAWAY. So if CalPERS had said, we are going to buy——

Mr. JOHNSTON. We are going to buy $7 billion worth of commodities.

Mr. CONAWAY. But if CalPERS had said we are going to buy that much in stocks, wouldn't that have been the same thing?

Mr. JOHNSTON. Stock is different.

Mr. DUFFY. With all due respect, sir, if I could just clarify—55,000 contracts is the number I think you stated. The volume on the New York Mercantile Exchange on any given day is about two million contracts. So you are talking about a very small percentage of an order going into the marketplace. We are not ever saying that one large buy order or one large sell order cannot have a short-term effect on a market. But it always goes back to equilibrium.

So I think that it is very misleading when he is trying to tell the Committee 55,000 is a lot of contracts. It is not. CME Group trades 15 million contracts a day.

Mr. JOHNSTON. Okay.

Mr. CONAWAY. Thank you, Mr. Chairman.

The CHAIRMAN [presiding.] The gentleman from North Carolina.

Mr. ETHERIDGE. Thank you, Mr. Chairman. Let me thank each of you for being here.

For those who are watching this today who are probably not familiar with this, they all think they are short if they are consumers. I guarantee you, my folks at home, the farmers, the mer-

chants, everyone really believes they are being short, and so they are trying to get to this so we get some balance back in this thing.

Mr. Johnston, let me ask you a question. Mr. Duffy described the purpose of margins as a performance bond designed to ensure that contractual obligations are met and that the clearinghouses can fulfill their responsibilities. My question to you, do you agree with this description, or do you think margins serve another purpose?

Mr. JOHNSTON. I think they serve another purpose.

Mr. ETHERIDGE. And would you explain.

Mr. JOHNSTON. Well, if we were in the 19th century, I would say that is true, it was a true statement. But since the 1980s, when we had managed futures and there was a great concentration of capital in and around futures and it has morphed into this marketplace that it is now, margins can and should mean more. And right now we need some form of intervention rate in order to stop what is happening to energy.

And when I suggest saying, just raise margins on the longs, I guarantee you, that will have an impact. It will soften what is going on in terms of the up move. It will actually make it go down. Because you are taking a situation where there is tremendous asymmetry of resources, where you have this community of people who have trillions of dollars to allocate. And they are not really thinking that well. They are saying, "Okay, well, let's throw a few billion here, and we will put a few billion there and we will see what the returns are." Well, in the little world where people are actually working and buying this stuff, it is having tremendous impact. So I am saying, let's have an ascending rate of margins. If you have 10,000, you pay a minimum margin. If you have 20,000, well, you pay 50 percent. So you think, gee, do I really want 20,000? And if you are going to go to the area where you are carrying 30,000–50,000 contracts of futures, I think you should be putting up the full amount cash. If they have the bills, let's see 'em. Bring 'em in. Let's see 'em. Put them up.

Mr. ETHERIDGE. Let me follow that with the following question, and I will let the others comment if we have time left. You advocate, as you just said, margin requirements for over-the-counter transactions as well, given the over-the-counter participants separately negotiating the credit risks associated with the swap and the swaps often are, as you well know, unique tailored estimates and agreements that differ from each other. I guess my question would be, how would the CFTC impose the appropriate margins on each over-the-counter transaction? And if they do, do you think the CFTC has the resources to perform these functions? Or what should we do to deal with that?

Mr. JOHNSTON. I don't know. And I don't know.

Mr. ETHERIDGE. I guess that is an answer. Do either one of you want to comment on the previous two questions?

Mr. KEITH. I would like to comment on the concept of having higher margins on the longs.

Mr. ETHERIDGE. Longs. Thank you.

Mr. KEITH. We don't think that is the right approach. We think we are going to run into situations where we have funds that are net short. And some people are going to accuse the funds then of forcing prices lower more quickly than they would be otherwise.

And what are we going to do? We are going to switch on the downside and penalize the people that are going short with higher margins? I think that that is just not good Federal policy.

Mr. DUFFY. I would like to echo those comments. Margins, as in my testimony, is no way to effectuate price whatsoever. We have seen prices increase in crude oil, we have seen price goes up in grain products. And the margin goes up but the price doesn't come down. It is strictly there based on volatility to protect the integrity of the clearinghouse. It has nothing to do to affect the price and I completely agree with Mr. Keith. You have people on both sides of this market. You are going to create yourself an issue. I guarantee you, if corn starts to go down, and these funds are big shorts and start to add onto positions, you will be sitting in this room trying to figure out how to get rid of $1.50 corn then. Now what are we going to do? We are going to raise the margin for the shorts again. Then we will get back to the gentleman on the left to fix his problem again. It is just ludicrous to think that margins have anything to do with price.

Mr. JOHNSTON. Can I respond to that?

Mr. ETHERIDGE. We have about 20 seconds.

Mr. JOHNSTON. I think it is essential you weigh out the effect of what is happening to people in energy right now. Like you say, they are losing their jobs, they are losing their businesses and we need to deal with this. We need to get this price to stop doing what it is doing, and through margins we will do that cheaply and quickly.

Mr. ETHERIDGE. Thank you. Mr. Johnston, just a final point. You are making proposals dealing with margins, and you didn't know on the other one. I would suggest you go back and research that. We would appreciate having a response on that in writing because you made some pretty broad proposals here, and then you don't know what those proposals do.

Mr. JOHNSTON. I don't have any experience in OTC.

Mr. ETHERIDGE. Well, I would appreciate you taking a look at that and getting back because that would have an impact just like it did on the other markets.

I yield.

The CHAIRMAN. The gentleman from Georgia.

Mr. MARSHALL. Thank you, Mr. Chairman. I find myself in agreement with Mr. Duffy's remarks concerning the purpose of margins and the likely effect of different proposals that have been made. It just seemed to me that risk management models that have been developed by CME and others are truly models for the industry generally. Frankly I think the SEC and that entire side of the financial services industry is well behind the times in appropriate management of risk.

I don't, however, agree, Mr. Duffy, with your assessment of the impact of this passive money. I think Mr. Johnston has a better case there based on what I have been hearing for several days now. It is not that I feel like I have a complete handle on this. I don't think anybody really does have a complete handle on this. I think that in a sort of abstract theoretical world somebody like Dr. Pirrong could feel like he has got an abstract—a perfect handle on this. But I don't think we live in that abstract theoretical world.

I think Mr. Johnston's description is consistent with the description we are getting from any number of other people, the impact of this, and it makes common sense. It just seems to me the burden is on others to suggest that money like this wouldn't have an impact. It is the burden on them to prove it. Because just common sense and the way markets typically work, money like this does have impacts like that. So I just don't think that, Mr. Johnston, this is the solution, that it would have all the negative impacts that Mr. Duffy suggests it would have, and frankly Mr. Keith agrees.

Mr. Keith, I find most of your suggestions to be quite reasonable, things we ought to be doing. I think we ought to be considering those things.

Mr. Johnston, let's assume that you are right and that there is the problem present that you described, and many others described, and that we need to make some action quickly to deal with it. I think you were here earlier. You heard me suggest that perhaps the way to do this is to have federally set position limits that apply to all the players and then to provide that it will be a Federal criminal penalty, a felony subject to jail time by any device or mechanism to attempt to circumvent those federally set limits; with the idea that anybody is welcome to come and play in the futures market for whatever reasons but only to a certain extent.

Would that have the same beneficial effect that you are looking for?

Mr. JOHNSTON. If I had known you were going to say that, I would not have gotten up at 2 this morning to drive all the way down here to talk to you.

Mr. MARSHALL. Wait a minute. I am just one voice here.

I think I was a voice all along who—and I still think that the long-term fundamentals where supply and demand on oil, where price is concerned, are absolutely heading toward higher prices. There is just no doubt about it. We have to take some action. The dollar's a big problem. I mean, there are a lot of things that are causing this. But part of it, I am persuaded, is what you are describing. How much, I don't know. But these markets were never intended as a place to park your money and just have a position in.

The price discovery function is disserved by that. The confidence that people have in the market is disserved by that, which is bad generally for American markets, for all of our financial markets. I think that a simple solution might be what I described. That is what we did years ago with ag commodities once we started having these same problems where the ag commodities are concerned. And the reason for Federal criminal penalties, frankly, there are all kinds of devices to circumvent this if you want to. But if it is a criminal problem to circumvent it, then maybe you won't. What do you think?

Mr. JOHNSTON. I think it is a great idea. My concern is how long will it take to put it in place? And the risk of the market right now is not unlike sugar in the 1970s or silver in early 1980. I mean, there is an inadequate amount of liquidity for whatever reason to satisfy the buyers. And the slightest thing, whatever it could be crude could go up $20 in 1 day and go up another $20 the next day. I think it is up $10 in the last 24 hours.

Mr. MARSHALL. Well, it seems to me the market is very savvy, much savvier than we are about its business. And if it sees Congress heading in the direction I described, don't you think it is that savvy? It seems to me people are going to start thinking about liquidating their positions.

Mr. JOHNSTON. It is not going to change the architecture in the market right now. This setup that we have doesn't happen all the time. It used to happen when some guys would get together in plaid pants and foot-long cigars and say, hey, let's squeeze orange juice. This is an accident. It was a great idea; 15 years ago some smart guys got together and said, "If we do this, it will be good for the overall portfolios." But it has morphed. It has turned into this massive growing monster. And the liquidity that is available facing the market now, I mean it is in the background of a very of positive supply-demand fundamental anyway. There is growth. There is use of energy. You add this kind of turbo-charging absence of liquidity to the market, and you are risking something that only commodity markets can do.

If I sat here last November and said we would be trading $150, would you believe that? Would you have said, that guy is crazy. We are not going to $150. Well, here we are at $150. There is no sign that this is going to change at all. Not any amount of, like, down the road we are going to do something with limits. That is not going to stop it. That is not going to stop it. You have to be able to do something now. Otherwise what we are hearing from these people is that there are going to be people that are starving and freezing and dying and all that other stuff. And that is not what it is about. That is not what the market, the free market is for.

Mr. MARSHALL. Mr. Johnston, thank you, sir. I yield back.

The CHAIRMAN. I thank you the gentleman. The gentlelady from South Dakota.

Ms. HERSETH SANDLIN. Before the hearing today, I had been persuaded by conversations I had been having that higher margins were not the answer, and I still find fairly persuasive Mr. Duffy's explanation for why that would cause some problems.

But Mr. Johnston, you are putting forward some interesting analysis, and I think my colleagues on the Committee have done a good job of exploring some of this with you. Rather than the back-and-forth that we have had here, though in terms of where we need to go with further evaluating this particular issue, I do want to go back to a more general question for all of you. I think that Mr. Keith, you may have answered it in a comment that you had made with regard to transparency for nontraditional participants. But what are each of your thoughts on how important it is to examine and redefine who is in the markets? I guess that will include both on and off-exchange and the decision of whether an update of these definitions and players is needed. And if you think that it is needed, how do we best accomplish that goal? And if you don't think it is needed, why not?

Mr. DUFFY. I would be happy to take that, Congresswoman. You know, we as the largest regulated futures exchange not only in the U.S. but in the world, we agree with that. We agree with transparency. It has been something we have been on the record for many years here in Congress calling for more transparency. We

have called for the elimination of the exempt commercial market over the years. We have been doing all that.

I think the CFTC has done a terrific job. You heard Mr. Greenberger make some comments earlier where he thought the steps that they have taken have addressed a lot of the issues. And that is the first time I have agreed with Mr. Greenberger, but there are a lot of things that have gone on lately that are the right things. But we have been abiding by this all the along, and that is what a regulated futures exchange does.

So the makeup of the participants, we have commercials *versus* noncommercials; on the hedge fund stuff, the exemptions. I just wanted to make one other comment about that because it is a class of traders that I think is important from the CME Group's perspective. As we have seen the price of wheat, corn and soybeans go to $18, $16 and houses floating down streets, we can understand why these products are doing what they are doing. But we have seen a decrease in the participants of these so-called passive long onlys and these products in face of grain products doing what they are doing.

So the arguments to my left just don't make any sense. So I am sorry to get off topic a little bit, but I think that the makeup of the participants is being watched carefully and effectively on regulated exchanges.

Ms. HERSETH SANDLIN. I am glad you went off topic a little bit because as you did, it sort of raises the issue that we are trying to get at and that is the immediacy of this issue. I agree the CFTC has taken some important steps. But I also believe strongly they wouldn't have, absent the Congressional pressure to do so, because for weeks they claimed that there was no problem. The fundamentals were solid. They didn't need any additional authorities; resources maybe but authorities, no.

Well, again, as I mentioned, I am persuaded by a lot of what you say about the potential effect of higher margins. What is the best solution? Because we can't sit back—I think there has to be some Congressional action here.

Mr. DUFFY. We are not disputing what you are saying, Congresswoman. I am not going to defend the CFTC on what their actions were. We were on the record going back as far as 2002 calling for some of the exemptions that were put into place. So there is no disagreement from CME Group.

Ms. HERSETH SANDLIN. So in addition to agreeing that greater transparency about all the players in the market but disagreeing that higher margins, whether it is higher rate of——

Mr. DUFFY. Absolutely.

Ms. HERSETH SANDLIN. What else do you think based on the legislative proposals that have been introduced to date? Do you agree with any of the other provisions in addition to enhanced transparency or authorities for CFTC? What else do you think might be a good tool to use to address this issue and the problems for our constituents that were best articulated so far today by Mr. Kagen?

Mr. DUFFY. Again, I will go to the one single word which I think makes the most amount of sense, and that is transparency and reportability and accountability. That is what a regulated futures market does, that is what the New York Mercantile Exchange does,

that is what the CME Group does. So those are the only exchanges I can speak to as the regulated exchanges. I think we are doing exactly what Congress has mandated us to do through the 2000 Act.

Ms. HERSETH SANDLIN. So on the accountability issue, what are your thoughts on Mr. Marshall's suggestion about criminal penalties?

Mr. DUFFY. Mr. Marshall very well knows as the rest of the Agriculture Committee knows, position limits in agricultural products at the CME Group are set by the United States Government, not by any particular entity. So we agree with him on the limits as it relates to our grain products. As it relates to energy products, there are accountability limits until the last 3 days, and then they go into hard limits. Pre-2000, I believe those were all hard limits going into that. So I am assuming that is where Congress is going to take a look. I am assuming that is what Mr. Marshall is referring to.

Ms. HERSETH SANDLIN. Thank you.

The CHAIRMAN. I thank the gentlelady. The gentlelady from Kansas.

Mrs. BOYDA. Thank you very much. I am going back to the same kind of question that I had earlier. If you think this is mainly market-driven, then why has the price of a barrel of oil tripled in a year and a half?

Mr. DUFFY. Why has the cost of corn tripled in a year?

Mrs. BOYDA. You could say because oil has tripled.

Mr. DUFFY. We can see why these are happening in agricultural products. I don't think there is anybody denying in this room or anywhere else why we are seeing the price of agriculture doing what it is doing. We have every foreign government putting tariffs on the United States on exports——

Mrs. BOYDA. Excuse me. I have just a little bit of time here. Let me go back to oil. We have seen oil basically triple. Demand hasn't really substantially changed. The price of the dollar, cost of the dollar, the valuation of the dollar hasn't changed that much. What would you say is causing oil to basically triple?

Mr. DUFFY. I think the market in all honesty is anticipating higher prices down the road and that is what it does. If you look at a futures market——

Mrs. BOYDA. This is mainly psychological?

Mr. DUFFY. On WTI, the market is anticipating both commercials and processors and users. In 2012, for delivery on the NYMEX, they are looking at the crude oil at $140 a barrel. So in turn, the spot goes there. If you could fix problems today, that may take us several years and take the deferred price down, I am assuming that would affect the spot price also. So it is just anticipation of what the future looks like.

Mrs. BOYDA. But there isn't anything that is really——

Mr. DUFFY. I don't know. I am hearing that there is a finite amount of this supply and there is an appetite for more of it. I am not an oil expert, ma'am. So I will be somewhat careful. I just understand how futures markets work and what people are telling you what they think.

Mrs. BOYDA. Do you think——

Mr. DUFFY. Those aren't just speculative——

Mrs. BOYDA. Do you think when the oil companies say, "By the way, we don't have one piece of equipment to drill anymore," what do you think that does to the price of a barrel of oil? Is that the sort of thing you are talking about?

Mr. DUFFY. I find that hard to believe actually, but——

Mrs. BOYDA. What?

Mr. DUFFY. That they don't have any money to buy one piece of oil to drill——

Mrs. BOYDA. Well, they have the money. They have a lot of money. Obviously we know that. No. There is not a rig around. The American Petroleum Institute said here a couple of weeks ago that, "No, we don't have any drilling equipment. We have leases out the Ying Yang, but we don't have any drilling equipment."

Mr. DUFFY. What was their answer?

Mrs. BOYDA. There wasn't an answer. That was just stated as a given. What you are saying is if this is market driven, then basically what you have done—we all know now we have 68 million acres of land on shore, as well as millions of acres of land on the Outer Continental Shelf as well as in Alaska, apart from ANWR, that are drillable today with larger resources than any of this ANWR stuff that people are trying to—so what you are saying is that ultimately panic is driving the marketplace.

I know you are not an expert; but what you are really saying is that this is driven by some fear. So, when the oil companies say, "Gee, we don't have any more equipment," then that is what you would say would be driving the market. Mr. Johnston would say it is actually more boys at the party than girls at the party. But you are saying that it is this fear that we are not going to have a supply.

Mr. DUFFY. It is anticipation of price. And it is no different if it is up or down. That is what the futures markets do. They give people an opportunity to manage the risk into the future and that is what the WTI market is telling us today, that they believe——

Mrs. BOYDA. You think it is the oil companies—I am just speculating here myself. And I am just having a kind of conversation and I know you are not the oil company. But if you think they said, "Oh, my gosh, we just took ownership of ten new rigs and we are going to start drilling," do you think the market, in fact, would come down? So this is just in anticipation?

Mr. DUFFY. I do not know if that is something——

Mrs. BOYDA. But what you are telling me is that that is why the market has gone up.

Mr. DUFFY. No. What I read from the President of Gulf Oil in his op-ed yesterday in *The Wall Street Journal* is saying that if they were to do certain things, they believe the market would come down. But right now they are not doing it. Certain things mean drilling.

Mrs. BOYDA. They don't have any drills. They don't have any rigs. They said that.

Mr. DUFFY. I don't know if that is what Gulf Oil is saying. I am just telling you what I read yesterday in *The Wall Street Journal,* and he is talking about the deferred futures price of oil being at $140 a barrel. He is saying it is because of the supply equation that we know we have today. He says if you start to do things that

could affect the price 5 years out, he believes that will affect the spot price of today's market. And that's reporting from him.

Mrs. BOYDA. I will yield back in a minute. But what you are saying again is if I were an oil company and I wanted to drive supply down and constantly be out there in the market talking about that, that that would be enough then to drive the prices of oil up—because, in fact, you are limiting supply. They can drill until the cows come home. I am from Kansas, I can state that. I think it is a very compelling argument, but what you are ultimately saying is that the supply and demand hasn't changed very much, the dollar hasn't changed.

Mr. DUFFY. I did not say that.

Mrs. BOYDA. I am saying that. It hasn't changed enough to warrant a threefold increase. But if you have somebody out there beating the drum, saying this is all supply driven, then you are saying it is that fear of it that is going up because you haven't yet given me anything that I can really bite my teeth into and say this is the supply and demand future that I can now take home. It is all basically this fear of what is going to happen.

Mr. DUFFY. I think you stated the fact earlier there were 88 million barrels a day——

Mrs. BOYDA. Sixty-eight.

Mr. DUFFY. Whatever the number was.

Mrs. BOYDA. Sixty-eight million acres of land that are——

Mr. DUFFY. I am sure you are also aware that we planted 94 million acres of corn in 2007 and according to the government mandate for ethanol program, by 2017 a third of those acres will go away just for the ethanol program. So we want to go to talking about how we are going to feed our people. We have other issues associated with it. So there are a lot of issues in this energy and I don't think I can solve them in this hearing right now for you.

Mrs. BOYDA. All right. Mr. Johnston, I don't understand the six girls and four boys. I think I am beginning to understand some other things. Thank you.

The CHAIRMAN. I thank the gentlelady. The gentleman from Wisconsin.

Mr. KAGEN. Thank you, Mr. Chairman. Mr. Duffy, thank you for complying with all the Federal guidelines. I know how difficult it is. We don't mean to make your job any more difficult or challenging. And I appreciate the services that you offer. One of the essential elements in my colleague Mr. Etheridge's bill has to do with transparency. So can you tell me what percent of the contracts in the CME are being purchased and sold by pension funds?

Mr. DUFFY. I don't have an exact number. Pension funds have a limit of a percentage of how much they can invest and diversify into our marketplace. I think it is roughly four to five percent. So that would be in several different products. We have asset classes from everything from interest rates, to foreign exchange, to equities, to agricultural products and alternative investments such as real estate and weather.

Mr. KAGEN. From the information that you are aware of, are the pension funds a major investor in oil commodities?

Mr. DUFFY. I would not have that information, sir.

Mr. KAGEN. So we don't have that information?

Mr. DUFFY. I would not have it. We don't run the oil business.

Mr. KAGEN. So you don't keep that information. Your friend and colleague, Mr. Johnston, has suggested that perhaps increasing the margins, the limits—let us call it the limits—on longs and passive longs is a meaningful way to control this herd mentality. What do you think about that?

Mr. DUFFY. Well, I respectfully disagree and I agree with what Mr. Keith said. I think if we have a problem to the down side of the market, are we going to impose higher margin requirements for the short side of the market because they are taking the price too low.

So I just completely disagree with it. I don't believe in two-tier markets. I don't believe they are effective and I don't think they suit the needs of what everybody has said in this room. They are intended to be there for the commercial use and now they are going to have a lopsided approach to it. So you could hurt the liquidity. In all honesty, sir, that will hurt the processor, the producer and everybody else involved with their product.

Mr. KAGEN. Do you have an opinion as to whether or not pension funds should be allowed to invest in commodities?

Mr. DUFFY. They do today, sir. I think that diversification is critically important for anyone's portfolio. I am a member of the Federal Retirement Thrift Savings Plan. I am a fiduciary for the government in that respect. And when you are sitting there with just long haul equities and the market is going down, I mean, it is a very painful event. I think people should have the opportunity to diversify into asset classes such as commodities to offset some of the inflationary needs. And that is what exactly what they are doing.

Mr. KAGEN. Earlier today there were references made to the CFTC extending a letter on July 3rd to apply some additional rules and regulations to ICE and Dubai markets. Do you feel that that letter that I am holding here, that this letter would, in action, be effective at all in reducing the oil prices?

Mr. DUFFY. To give them increased—I am sorry, sir. What was that for?

Mr. KAGEN. Would the recent action of CFTC have any implication to bringing down oil prices?

Mr. DUFFY. The CFTC requiring ICE to comply with the same rules that the NYMEX has?

Mr. KAGEN. Yes.

Mr. DUFFY. I don't believe that affects the price one bit, sir, no.

Mr. KAGEN. Does it help with transparency?

Mr. DUFFY. I think it does help with transparency.

Mr. KAGEN. Okay. Mr. Johnston, do you care to comment on any of the questions I've asked?

Mr. JOHNSTON. Yes. First of all, when Bear Stearns was in trouble and it looked like there was going to be a big problem on Wall Street, there was an intervention policy to deal with the crisis. And I think crude is in the same type of crisis. So when I say we should raise margins on longs, I am not trying to just inhibit pension fund behavior. I say pension fund behavior is essentially a part of the cast of players causing the problem. We need to understand that and I have tried to give you a new look or a new point of view on

what is happening there. But when I say raise margins on longs, I want you to consider doing something that will be effective immediately, now. And I want you to hand them a weight, a handicap. The asymmetry which is now occurring and it occurs occasionally, it doesn't always happen in crude. It happened with beans in the 1970s. Every now and then, things get out of hand.

Mrs. BOYDA. Will the gentleman yield?

Mr. KAGEN. Not right now. You are looking for immediate action as everyone is. I have asked the President as has the leadership of this Congress to immediately release 500,000 or so barrels a day of our SPR to put more onto the market. Wouldn't that immediately drive prices down?

Mr. JOHNSTON. Let me think. In the past the long position was equal to about two billion barrels right now. So yes, that would add up. It would take time, but it would add up.

Mr. KAGEN. It is a temporary measure.

Mr. JOHNSTON. It is temporary. Two things would happen. If you could persuade the pension funds either through moral persuasion or otherwise that what they are doing is self-immolating, that every time they buy another barrel of crude oil, they are destroying the stock portfolio they are trying to defend. So maybe they would say that makes sense. We have enough, we will stop. That has happened before.

Mr. KAGEN. Wouldn't it also be a wise move to have a national energy policy?

Mr. JOHNSTON. I agree with that 100 percent. I think anything you can do now—maybe I am wrong on margins. It is not something that I was trained to do. I trade. And I am only talking about that from the point of view as a trader. If I heard you were raising margins on longs from four percent to 50 percent, I would say that is it, I am not trading crude anymore. I just wouldn't do it. I don't know of a single trader that I know—and I know hundreds—that would say, okay, I am going to trade crude today. They would just stop. That is it. If a guy was going to sit down at Morgan Stanley or JPM, and he was planning on buying a million barrels of crude today and he had to put up a million barrels of crude, $150 million—he had to put up $70 million, his trading manager would probably say "No, you are not doing that."

Mr. KAGEN. Thank you very much for your response. I see my time has expired and I will yield back.

Mrs. BOYDA. Mr. Chairman, could I ask one more quick question?

The CHAIRMAN. If you are quick.

Mrs. BOYDA. What would a temporary—would there be any temporary margin increase that——

Mr. JOHNSTON. How does it start and how does it stop?

Mrs. BOYDA. Right. And how long—if you made it temporary, what would be the shortest time that you could do this in order to—and what would the effect of that be?

Mr. JOHNSTON. This is guessing. I have seen the effect of raising margins. Ultimately, if you raise them equally as Mr. Duffy said, it would be toxic. It would just cause crude to explode because it would put tremendous pressure on the short. And since we have asymmetry in the auction as it is, where it is really the long side that is the problem, coming from the passive long——

Mrs. BOYDA. If we went with your proposal for what you are talking about, what is the shortest amount of time and what would be the effect be of a short drive?

Mr. JOHNSTON. Depending on how high you are willing to raise the margins, I think it would go below $100 almost immediately.

Mr. DUFFY. No.

Mr. JOHNSTON. I think it would go straight down.

Mr. DUFFY. Mr. Chairman, could I respond real quickly, sir? One second. Two things. First of all, there are business plans in this country that have long hedges on energy that you would be distorting their whole business plan that they put into place many months or years in advance. One being Southwest Airlines. I don't know if they are still technically long hedged crude oil to protect their business model, but you would be distorting an American business model, changing the rules of the game after they did it and they are in a very fragile situation also.

That is irresponsible for someone to testify on that and to say that is a good business plan. Second of all, we have no evidence that margins on long investors would affect the market whatsoever. We have clearly shown in our testimony that these passive long onlys already put up the full value of this contract today, it is just held in a separate account. So they would shift that money over right to the other account, you would not affect the price one bit. You would affect business models that are based on long hedging already.

The CHAIRMAN. I just want to weigh in and let people know that I am totally against this idea because it is going to be a negative for my farmers and they already have enough problems out there with the margin situation. Mr. Keith, I would guess you agree with that.

Mr. KEITH. Yes.

The CHAIRMAN. I have farmers that can't get a forward contract right now because the elevator can't afford the margin calls. So the last thing we need to do is raise these margins. I agree. I don't think it is going to affect the price one way or the other. Now, my question is, can't you accomplish the same thing by putting position limits, getting rid of the hedge exemption and putting position limits on these vehicles? Couldn't you do the same thing?

Mr. JOHNSTON. Me?

The CHAIRMAN. Yes.

Mr. JOHNSTON. Yes, you could if you could do it now.

The CHAIRMAN. Pardon?

Mr. JOHNSTON. Can you do it now?

The CHAIRMAN. Sure. We can pass a bill that says—well, we can set them ourselves, which I think would be a dumb idea because we don't—I guess we could get together and figure out amongst ourselves what the position limit of oil should be. That would be an interesting experiment. But, more likely we would give the CFTC a short period of time to develop position limits. We have them in agriculture; they work. As I understand it, people get together, the folks that are involved in this, and give advice to the CFTC and they set these limits, right?

Mr. DUFFY. The government does, yes.

The CHAIRMAN. Or we could do that with oil. We would do it short order. We could give them 90 days and tell them to look at this and do it. We are going to have information back that is finally being collected by the CFTC right now. By the first part of September, we are going to know this information about these swaps and what all is going on here with all of this stuff that is now in the dark market. We are going to know that information in September. So I think there are other ways to get at this. I think what you are proposing would work, but one of my bottom-lines of this whole situation is I am still not totally convinced how much effect the speculators are having on this price. I understand people don't like to pay this price for gas and they are looking for somebody to blame and the speculators might be part of it. They probably are some part of it.

But the bottom-line for me is that in agriculture, we are the people that started this whole thing in the first place. We depend on this. The last thing I want to do is to do something here in response to some political pressure in gasoline that is going to screw up the agriculture markets. And bottom-line, that is where I am coming from. I think these margin ideas will screw up the ag market eventually—potentially.

Mr. MARSHALL. Mr. Chairman, over here. May I just add on to one thing?

The CHAIRMAN. Sure. Briefly.

Mr. MARSHALL. Mr. Johnston, I wouldn't expect you to know this, but our laws currently provide for criminal penalties for fraud or market manipulation. Basically we don't want somebody going out there and intentionally skewing things in order to affect prices. In a sense, if we did something as odd as step in and target longs in some specific way, we the government—of course, we can get away with it, because we are the ones that make the laws and they don't apply to us—but we the government would be guilty of going in there and doing exactly what we provide criminal penalties for others doing.

So I just don't think we are going to head in the direction of fooling with frankly a great risk management model that has been developed here. The direct way to deal with this, to me at least, is with position limits that work. The testimony is they don't work because people just go off-exchange and circumvent them and so we just make criminal penalties for circumvention. I just don't think the industry is going to be interested in subjecting itself to criminal penalties. Going back to price discovery, market confidence and people who want whole commodities, there are other mechanisms for doing that. This never was intended for that purpose.

The CHAIRMAN. I thank the gentleman. I thank this panel. You did an excellent job. We appreciate your making your expertise and time available to us. We will call the next panel, which is called the miscellaneous and general panel. We have Mr. Tim Lynch, the Senior Vice President of the American Trucking Association; Mr. Daniel Roth, President and CEO of the National Futures Association; Mr. Tyson Slocum, the Director of Public Citizen's Energy Program; and Captain John Prater, President of the Air Line Pilots Association.

Welcome to the Committee. Mr. Lynch, all your statements will be made part of the record. And any Members that have statements will also be made part of the record. We would ask you to summarize and try to limit to 5 minutes and I appreciate your being with the Committee. Mr. Lynch.

**STATEMENT OF TIMOTHY P. LYNCH, SENIOR VICE PRESIDENT, AMERICAN TRUCKING ASSOCIATION, ARLINGTON, VA**

Mr. LYNCH. Thank you, Mr. Chairman and Members of the Agriculture Committee for giving us this opportunity to present our views on the impact of escalating prices on our industry and our suggestions for addressing the problem, including those related to the Commodity Exchange Act. The trucking industry is the backbone of the nation's economy, accounting for more than 80 percent of the nation's freight bill. The U.S. trucking industry is comprised of over 211,000 for hire carriers and more than 277,000 private carriers. Over 80 percent of all communities in the United States are served exclusively by the trucking industry. Diesel fuel is the lifeblood of the trucking industry. We will consume some 39 billion gallons of diesel fuel this year. The national average price of diesel is now over $4.70 per gallon, which is nearly $2 more than just 1 year ago. While most of us feel the pain of higher fuel prices when the gas pump reads $60 or $70, it costs a trucker approximately $1,400 to fill up and he or she gets to do that twice a week. In fact, fuel has now surpassed labor as the single largest operating expense for most truck companies. These costs have a dramatic impact. In the first quarter of 2008, 935 trucking companies with at least five trucks closed their doors. It is very likely that an even greater number of single truck operators have also turned in their keys. This is the largest number of trucking closures since the third quarter of 2001. According to the Department of Labor, over 10,000 individuals employed in the trucking industry have lost their jobs since the first of the year. Beyond the trucking industry, these costs will have a ripple effect throughout the economy. Trucks transport virtually 100 percent of groceries, medicine, clothing, appliances and even the fuel that is pumped at the local service station. We believe that the dramatic run-up in petroleum product prices is the result of a confluence of factors, including increases in worldwide demand, failure to have a supply to keep pace with demand, the risks associated with geopolitical instability and weather, and certainly the dramatic decline in the value of the dollar.

But taking all those factors into account, we find ourselves still asking the question, why now? All of the items I just mentioned have been in play for an extended period of time, and certainly did not begin on January 1 of this year. Yet on January 1, petroleum was selling for under $100 a barrel. Today it is selling for over $140 a barrel or roughly 40 percent higher in just 6 months. During the past 5 years, the assets allocated to commodity index trading strategies have risen from $13 billion to $260 billion. We have been told that this figure represents only a fraction of assets, primarily from pension funds, but certainly other large institutional investors that could come into the commodities markets. Perhaps as much as $1 trillion.

So here is a very simple concern. If $260 billion can move the price of petroleum, even by the lowest of percentage estimates, then what will $1 trillion do and at what cost to the economy, to American businesses and certainly to thousands of truck companies large and small that simply cannot take that risk. Mr. Chairman, Members of the Committee, we cannot quantify the extent to which speculation is responsible for the recent dramatic increase in the price of crude oil. But we do believe that excessive speculation is part of the problem. For this reason, we believe that Congress should take steps to increase the transparency of the petroleum exchanges and establish reasonable position limits to prevent excessive speculation. Balancing the need for an efficient petroleum market with a desire to limit petroleum speculation could help burst any speculative bubble that has formed in the petroleum markets.

In conclusion, Mr. Chairman, we in the trucking industry generally talk in terms of equipment and tools. We view this as a tool in the toolbox. And we believe there are three of those. One is a saw to help us reduce demand. One is a hammer to help try and control some of these markets, and the third is the drill for more domestic supply. Thank you for giving me the opportunity to appear. We look forward to working with the Committee and we would be happy to answer any questions you may have.

[The prepared statement of Mr. Lynch follows:]

**Before the**
**U.S. House of Representatives**
**Committee on Agriculture**

**Statement of Tim Lynch**
**on behalf of the**
**American Trucking Associations, Inc. (ATA)**

***Hearing to Review Legislation Amending the Commodity Exchange Act.***

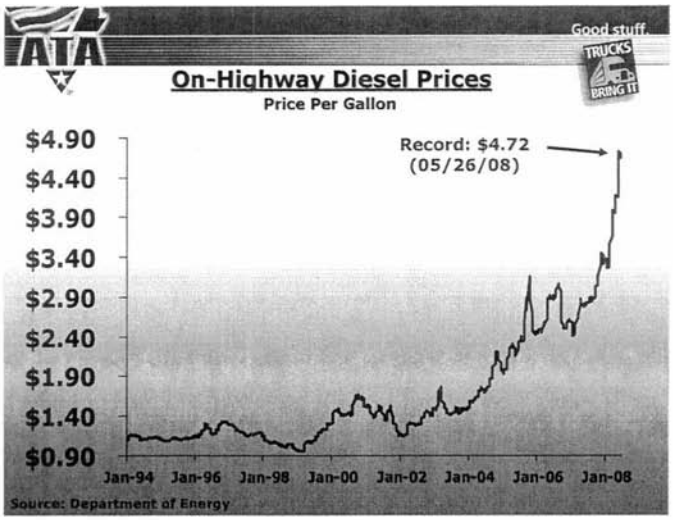
**July 11, 2008**

Mr. Chairman and Members of the Subcommittee:

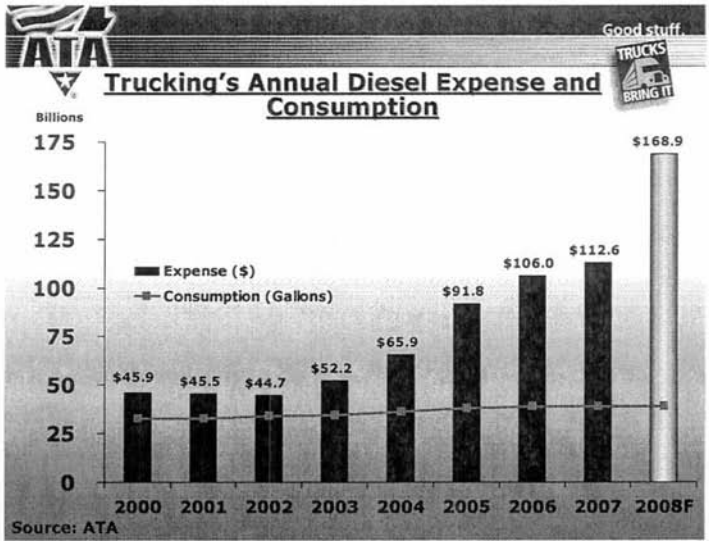
My name is Tim Lynch; I am the Senior Vice President of the American Trucking Associations (ATA). Through its affiliated state trucking associations, affiliated conferences and other organizations, ATA represents more than 37,000 trucking companies throughout the United States.

The trucking industry is the backbone of this nation's economy accounting for more than 80% of the nation's freight bill with nearly 9 million hard-working Americans working in trucking-related jobs. The trucking industry delivers virtually all of the consumer goods in the United States. We are an extremely competitive industry comprised largely of small businesses. Roughly 96% of all interstate motor carriers operate 20 or fewer trucks.

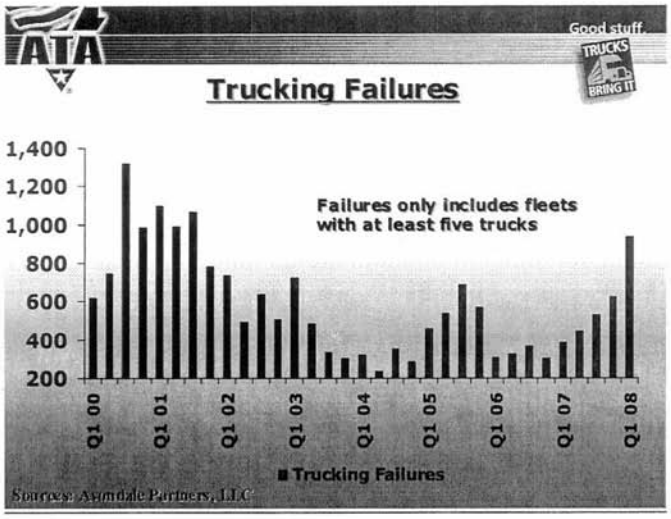
Diesel fuel is the lifeblood of the trucking industry. Each year, the trucking industry consumes over 39 billion gallons of diesel fuel. This means that a one-cent increase in the average price of diesel costs the trucking industry an additional $391 million in fuel expenses. The average national price of diesel fuel is now over $4.70 per gallon, which is nearly $2 more than just one year ago.




The trucking industry is on pace to spend an incredible $168.9 billion on fuel this year. This is $56 billion more than we spent in 2007, and more than double the amount we spent just four years ago.



Today it costs approximately $1,400 to refuel a truck. As a result of this dramatic increase in the price of diesel, which has coincided with a downturn in the economy and a softening of the demand for freight transportation services, many trucking companies are struggling to survive. In the first quarter of 2008, 935 trucking companies with at least five trucks failed. This was the largest number of trucking related failures since the third quarter of 2001. It is very likely that a large number of companies that operate fewer than 5 trucks also have turned in their keys during the first quarter of this year.



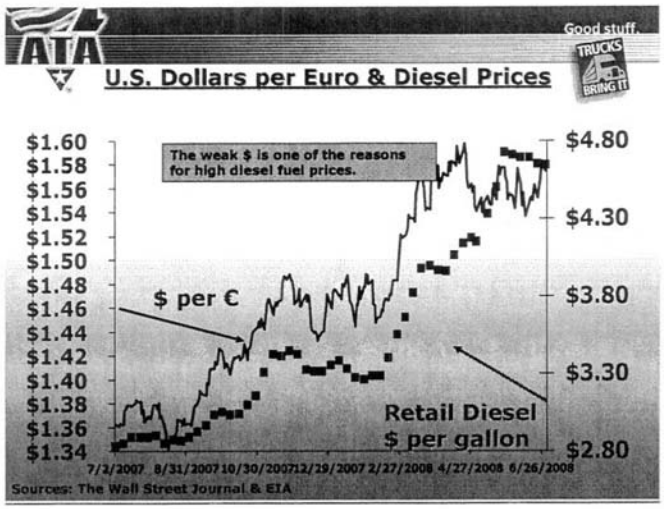

This hardship surprises few in the industry. For most truckers, fuel has surpassed labor as their largest operating expense. Over the past five years, total industry consumption of diesel fuel has gone up roughly 15 percent, while the price of diesel has nearly tripled during the same time period.

Trucking is a highly competitive industry with very low profit margins. This explains why many trucking companies are reporting that higher fuel prices have greatly suppressed profits, if they are making a profit at all. Our industry cannot simply absorb this rapid increase in fuel costs. We must pass some of these costs through to our customers. So not only do high fuel prices devastate truckers, but their customers as well, many of which are mom-and-pop stores. Ultimately, the consumer is forced to pay higher prices for food, clothing and other basic necessities.

### A. Why has the Price of Oil Increased 50% This Year

The dramatic run-up in petroleum product prices, including gasoline and diesel, is the result of a confluence of factors. First, there has been an increase in demand for

petroleum primarily from the rapid growth in China and India, but also from increased demand among Europe and the Persian Gulf countries. In addition to its rapid economic growth, China has increased its consumption as a result of the severe earthquake, which took traditional power generation facilities off line, and its petroleum supply buildup in preparation for the Olympics. Second, the supply of petroleum has not kept pace with the growth in demand for petroleum in recent years. U.S. domestic production has been declining as new sources of production have been placed off limits for environmental reasons, OPEC has not increased its production sufficiently, and production in Russia, Nigeria, Venezuela and Mexico has been inconsistent. Third, there is an increased risk premium on each barrel of oil. This risk premium is based upon geopolitical instability and a new found appreciation for potential supply disruptions from severe weather events. Fourth, we have borne witness to a dramatic decline in the value of the dollar. Five years ago, the dollar was at parity with the Euro. Today, the dollar is worth nearly 60% less than the Euro.




While the weak dollar has helped U.S. manufacturers export their goods, it has hurt U.S. consumers who have seen significant erosion in their purchasing power. Since oil is denominated in dollars, a large percentage of the increased price of oil can be attributed to the significant fall in the value of the dollar relative to other world currencies. Finally, we note that there has been a significant increase in the amount of dollars invested in the petroleum futures market and believe that this increased speculation may be driving up current commodities prices.

### B. A Comprehensive Solution is Required

Against this backdrop, we greatly appreciate the opportunity to discuss actions that Congress can take to help address the soaring price of diesel fuel. The fuel crisis we face today is severe. There is no one single solution to high oil prices and Congress must embrace a multifaceted approach to solving this problem. We are not going to be able to conserve our way out of this crisis. Nor will increased production provide a total solution. We are going to need every tool in the tool shed to address this crisis. Keeping with this metaphor, we need the hammer of government to ensure that petroleum markets are transparent and not subject to excessive speculation or manipulation, we need a saw to cut the demand for petroleum, and we need a drill to expand the supply of petroleum.

#### 1. The Hammer – Recommendations to Ensure Market Transparency and Prevent Excessive Speculation and Manipulation.

During the past five years the assets allocated to commodity index trading strategies have risen from $13 billion to $260 billion. The huge increase in dollars invested in the petroleum futures markets and the prevalence of exempt transactions and/or electronic exchanges that are not regulated by the Commodity Futures Trading Commission (CFTC) has led many experts to conclude that the current price of petroleum is artificially inflated and has departed from the fundamental market forces of supply and demand. While we cannot quantify the extent to which speculation is responsible for the recent dramatic increase in the price of crude oil, we believe that excessive speculation is part of the problem. For this reason, we believe that Congress should take steps to increase the transparency of the petroleum exchanges and establish reasonable position limits to prevent excessive speculation. At a minimum, Congress should require the CFTC to regulate the petroleum markets to the same extent that it regulates other commodity trading activities. Reasonable position limits should be imposed that ensure the ability of consumers of the underlying commodity to effectively hedge market risk while limiting excessive speculation from investors that have begun using the futures markets for asset accumulation.

Balancing the need for an efficient petroleum market with the desire to limit petroleum speculation could help burst any speculative bubble that has formed in the petroleum markets. Congress should consider the merits of expanding government oversight of electronic petroleum exchanges and establishing position limits to make it less attractive for Wall Street to speculate on petroleum prices, while ensuring that a robust market exists for legitimate purposes. Most importantly, we note that the recommendations to increase oversight and establish reasonable position limits are remedies that have no potential downside. Under a worst case scenario, the transparency of the market is improved, but the price of oil remains unaffected. Under a best case scenario, these remedies burst the speculative bubble that continues to grow, restores investor confidence in the futures markets, and drives asset accumulators out of the futures markets resulting in a relatively quick reduction in the price the oil.

**2. The Saw -- Recommendations to Reduce Demand**

Reducing the nation's consumption of diesel fuel will reduce the overall demand for petroleum and should result in lower prices for petroleum products.

1. Control Speed. The typical heavy-duty diesel truck travels between 5 and 7 miles on a gallon of diesel, depending upon load, route, equipment and drivers' skill. Speed has a direct correlation to fuel consumption. In fact, for each mile per hour that a truck travels above its optimal fuel efficiency point, its fuel economy decreases by 1/10 of a mile per gallon. For example, a truck traveling at 65 mph that is capable of achieving 6 miles per gallon, will achieve only 5 miles per gallon when traveling at 75 mph. For this reason, ATA recommends that Congress establish a national speed limit of 65 mph for all vehicles. Of course, to achieve the maximum benefit of this policy, the federal government will need to partner with States to ensure strict enforcement of the 65 mph speed limit.

ATA also has petitioned the Administration to require that all new trucks be equipped with factory-installed devices that electronically limit the truck's maximum speed to 68 mph. In addition to the fuel conservation benefit from ensuring that trucks do not exceed this speed, we are confident that this measure will further reduce the number of truck-related fatalities that occur on our nation's roadways.

2. Reduce Main Engine Idling. Truck drivers idle their trucks out of necessity. The Department of Transportation's Federal Motor Carrier Safety Administration (FMCSA) *Hours-of-Service* regulations require mandatory off duty rest periods. Many over-the-road drivers rest in the sleeper berth compartment in their truck cabs. As the driver rests in the truck's sleeper compartment, he/she will often need to cool or heat the cab to rest comfortably. In extremely cold weather, truck drivers also will idle their engines to prevent the engine block from freezing. Argonne National Laboratory estimates that the average long-haul truck idles for 1,830 hours per year. With hundreds of thousands of these trucks on the road, idling has a significant impact on fuel consumption and the environment. The U.S. Environmental Protection Agency (EPA) estimates that idling trucks consume approximately 1.1 billion gallons of diesel fuel annually.

Many options are currently available to reduce engine idling. Auxiliary power units (APUs) are among the most popular choices in anti-idling equipment providing climate control (heating and cooling), engine preheating, battery charging, and power for household accessories without use of the truck's main engine. APUs have been proven by the Federal Highway Administration to save up to one gallon of fuel per hour of idling and to substantially reduce emissions and greenhouse gases.

More than 30 states, counties, or cities have adopted regulations limiting the amount of time a commercial vehicle can idle. While reducing main engine idling is a laudable goal, three major barriers stand in the way of trucking companies purchasing such equipment for their daily use: (1) the failure to grant exceptions for the additional

weight associated with anti-idling equipment, (2) the imposition of a federal excise tax on the purchase of such devices, and (3) the actual cost of the devices themselves.

Since idling reduction equipment will add weight to a truck, many fleets do not want to reduce their cargo capacity to compensate for the installation of idle reduction equipment on a truck. To address this concern, Congress authorized a 400-pound weight exemption for trucks equipped with idle reduction equipment under Section 756 of the *Energy Policy Act of 2005*. While Congress' intent was to mandate this exemption, the Federal Highway Administration (FHWA) has determined that states "may" adopt the exemption on a voluntary basis. FHWA's interpretation of the weight exemption gives states the option of whether to allow the exemption or not. To date, seven states have passed legislation recognizing the 400-pound weight tolerance and a handful of states are exercising enforcement discretion. ATA asks Congress to clarify the 400-pound weight exemption as being applicable to idling reduction equipment nationwide.

A recent IRS interpretation applies the Federal Excise Tax (FET) to the purchase of idle reduction equipment, which has increased the cost of this equipment and consequently reduced consumer demand for these proven anti-idling solutions. The 12 percent tax acts as a disincentive to truckers looking to reduce main engine idling. FET makes the acquisition of APUs financially less attractive and beyond the reach of potential buyers. The tax alone for a large fleet looking to buy 1,000 APUs at a typical retail price of $9,000 is over $1 million. Taxing devices that offer truckers a solution to reduce fuel consumption and diesel emissions clearly sends the wrong message to the nation. By taxing APUs, we are doing a great disservice to both our economy and the environment. To address these disincentives, ATA asks Congress to amend Section 4051 of Internal Revenue Code to make idling reduction equipment purchases exempt from FET. This action will increase demand for the introduction of idling reduction equipment, thereby ensuring greater anti-idling compliance, higher fuel savings, and a cleaner environment.

While APUs are a proven alternative to main engine idling, most trucking companies just cannot afford purchasing devices that can cost up to $10,000 per unit. ATA is seeking financial incentives from Congress in the way of tax credits or grants to expedite the introduction of idling reduction equipment across the Nation.

3. Address Congestion and Highway Infrastructure. Americans waste a tremendous amount of fuel sitting in traffic. According to the most recent report on congestion from the Texas Transportation Institute, in 2005, drivers in metropolitan areas wasted 4.2 billion hours sitting in traffic. These congestion delays consumed 2.9 billion gallons of fuel. ATA estimates that if congestion in these areas was ended, 32.2 million tons of carbon would be eliminated and, over a 10-year period, nearly 32 billion gallons of fuel would be saved, reducing carbon emissions by 314 million tons. ATA recommends that Congress invest in a new congestion reduction program to eliminate major traffic bottlenecks, with a specific focus on bottlenecks that have the greatest impact on truck traffic.

4. Fully Fund EPA's SmartWay$^{sm}$ Program. In February 2004, the freight industry and EPA jointly unveiled the SmartWay$^{sm}$ Transport Partnership, a collaborative voluntary program designed to increase the energy efficiency and energy security of our country while significantly reducing air pollution and greenhouse gases. The program, patterned after the highly-successful Energy Star program developed by EPA and DOE, creates strong market-based incentives that challenge companies shipping products and freight operations to improve their environmental performance and improve their fuel efficiencies. To become a partner a fleet must commit to reduce fuel consumption through the use of EPA-verified equipment, additives, or programs. By 2012, the SmartWay$^{sm}$ program aims to save between 3.3 and 6.6 billion gallons of diesel fuel per year. EPA predicts SmartWay$^{sm}$ participants will also reduce their annual greenhouse gas emissions by 48 million tons of $CO_2$ equivalents. SmartWay$^{sm}$ is one voluntary greenhouse gas program that not only works, but exceeds expectations.

The trucking industry has fully embraced SmartWay$^{sm}$ and relies upon the innovativeness of this cutting edge program. However, while the program is growing by leaps and bounds, future funding remains uncertain. While ATA and other freight and shipping sectors continue to work towards ensuring a separate line item in future EPA appropriations for SmartWay$^{sm}$, we are troubled with the FY08 funding cuts to the program. More specifically, total monies allocated to the program this year dropped from roughly $3 million in FY07 to $2 million in FY08. Funding cuts to grants, contracting, marketing, technology development, and other program expenses have severely undermined the mission of the program. It is our hope that EPA will redirect an additional $1 million from the Climate Protection Program under the FY08 budget to ensure the continued growth and success of this remarkable program. Given that the Energy Star program's annual operating budget is $50 million, we also ask that Congress provide a line item appropriation to ensure that SmartWay$^{sm}$ is adequately funded in the future.

5. Enhance Truck Productivity. By reducing the number of trucks needed to move the nation's freight, the trucking industry can lower our fuel consumption, which would produce significant environmental benefits. More productive equipment - where it is consistent with highway and bridge design and maintenance of safety standards - is an additional tool that should be available to states. A recent study by the American Transportation Research Institute found that use of these vehicles could reduce fuel usage by up to 39%, with similar reductions in criteria and greenhouse gas emissions. The reduction in truck vehicle miles traveled on highways such as the New York Thruway, Massachusetts Turnpike, Florida Turnpike, and on roads throughout the Western United States, has lowered the amount of fuel burned in these states. These examples of responsible governance could be replicated by other states if given the necessary flexibility under federal law.

6. Support Truck Fuel Economy Standards. Congress should ensure that fuel economy standards for commercial medium- and heavy-duty trucks are technologically and economically feasible, do not compromise truck performance, and

provide manufacturers sufficient stability and lead time for production. Given that fuel economy in the industry has remained flat over the last quarter century and fuel now is the largest operating expense for many fleets, it is more critical than ever to increase fuel economy for these vehicles. ATA will be working closely with the U.S. Department of Transportation and the National Academy of Sciences as they evaluate fuel economy, fuel efficiency, and establish associated standards for medium- and heavy-duty trucks as directed under the Energy Information and Security Act of 2007.

7. Support Research and Development of New Technologies. Beyond the six aforementioned recommendations, Congress should fund research and development in the areas of new engine technologies, aerodynamics, low-carbon fuels, fuel additives, lubricity, tires, batteries, hybrids, anti-idling equipment, insulation, and rolling resistance specific to operations of line-haul trucks. Technology advancements have stalled for many years and an infusion of funding into an organized research program will be critical to developing the next generation of more efficient and lower carbon-emitting trucks.

### 3. The Drill – Recommendations to Increase Supply

The International Energy Agency has stated that global supplies may not keep up with demand through 2013 and that spare capacity from the Organization of Petroleum Exporting Countries will shrink, resulting in a "tight" market with little spare oil production capacity. The dramatic increase in the price of oil is partially fed by the perception that over the next few years there will be a shortage of oil as a result of the failure to invest in increasing oil supplies. For these reasons, in addition to reducing consumption and lessening the demand for petroleum, we need to focus on increasing our supply of crude oil.

1. Increase Domestic Exploration. ATA believes that increasing our domestic supply of crude oil will help lower diesel fuel prices. To achieve this goal we need to begin environmentally responsible exploration for crude oil in the Arctic National Wildlife Reserve and Outer Continental Shelf. We also must begin developing the oil shale and tar sands resources in Colorado, Utah and Wyoming and eliminating the barriers to utilizing coal-to-liquid technologies to exploit our vast domestic coal resources. The technology exists to ensure that these resources are developed in a manner that protects the environment. We also must consider the fact that drilling in Alaska or mining in Colorado requires Clean Air Act permits, Clean Water Act permits and land use development permits, all of which contain a host of environmental protections. Compare this to the drilling for oil in Venezuela or off the coast of Cuba with virtually no environmental protections. The debate over whether to drill in these areas of the United States has been ongoing for decades. In light of geopolitical instability, the growing demand for energy from Asia and Europe, and new drilling techniques to ensure that environmentally-sensitive areas remain protected and carbon emissions are sequestered, it is time to change these policies and develop these critical domestic resources.

2. Increase Domestic Refining Capacity. For years now it has been apparent that the U.S. has underinvested in refining capacity. Regardless of the reason for this underinvestment (e.g., environmental restrictions or economic factors), it is time to reverse this trend.

To help expand U.S. refining capacity, ATA has asked that EPA streamline its permitting process to facilitate refinery expansions and new refinery construction. Congress also should consider enacting incentives to encourage increased domestic refinery capacity.

3. One National Diesel Fuel Standard. While gasoline moves people, diesel fuel moves our economy. Due to the uniquely interstate nature of diesel fuel, ATA believes that Congress should take extraordinary steps to ensure that no state enacts a boutique diesel fuel mandate. Today, California and Texas require special boutique diesel fuel blends. These unique blends cost more to produce and prevent diesel fuel from simply being transported from one jurisdiction to another in times of shortage. In addition, boutique fuels are typically produced by only a handful of refineries, which results in less competition, higher refining margins, and ultimately higher fuel prices.

While Congress took steps to curb the proliferation of boutique fuels as part of the Energy Policy Act of 2005, the Act created a loophole for states seeking to enact renewable fuel mandates. To date, five states have enacted biodiesel mandates and several others are considering this course of action. In light of the recently enacted biodiesel mandate as part of the expanded federal renewable fuel standard (RFS), we believe that Congress must preempt state biodiesel mandates. These duplicative state mandates are not needed to ensure a strong domestic biodiesel industry and will simply create an economic environment where biodiesel producers can charge extraordinarily high prices for their product – insulated from the checks and balances of a competitive market. The federal RFS guarantees that 1 billion gallons of biodiesel will be consumed domestically – the free market must be allowed to operate to ensure that this mandate is achieved in the most cost effective manner possible. State biodiesel mandates will distort the free market and prevent biodiesel from being consumed in those parts of the country where it is most economical to do so. Congress should preempt state biodiesel mandates as inconsistent with our national interest and efforts to promote the cost effective use of biofuels.

In closing, we would be remiss if we did not applaud Congress' efforts to close the splash and dash loophole. We believe that the American public would be outraged if they knew that their tax dollars were being spent to subsidize biodiesel that is ultimately exported for sale outside the U.S. Beginning next year the Congressionally-mandated biodiesel standard will require U.S. companies to consume 500 million gallons of biodiesel. This number jumps to a billion gallons in 2012. For this reason, we do not believe that we should create an incentive to export subsidized biodiesel, which will drive up the price of this mandated alternative fuel for U.S. consumers.

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ATA appreciates this opportunity to offer our insight into measures that the country should take to help address the high cost of petroleum products.

The CHAIRMAN. Thank you, Mr. Lynch.
Mr. Roth.

**STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CEO, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL**

Mr. ROTH. Thank you, Mr. Chairman. My name is Dan Roth, and I am the President of National Futures Association. Over the years, I have testified at hearings before this Committee a number of times; and I have sat through a whole bunch more. And I know from sitting through those hearings that it is always sort of a tradition for every Member of the Committee and the witnesses to thank the Chairman for holding these hearings. Today that is a lot more than just a perfunctory gesture. The issues before this Committee today are profound, they are difficult, they are complex and they are very, very important to all of us.

I am glad that this Committee is taking such a leadership role because this Committee by far has the most experience with these markets, has, by far, the best understanding of how futures markets operate and how important they are to our industry. So again, thank you for the tremendous commitment of time and energy over the last couple of days from both the Committee Members and their staff. NFA is a self-regulatory organization for the futures industry. We regulate intermediaries, not markets themselves. We don't regulate the markets. We regulate the intermediaries that bring customers to the markets; the brokerage houses; the trading advisors; any category of registration under the Act that does business with the public, we regulate them.

A real cornerstone of the regulatory approach to these intermediaries is full disclosure. We require them to make full disclosure of risks to all their customers. The reason we wanted to be heard here today is, the issues you are discussing aren't directly NFA issues, but we became concerned over the last couple of weeks that maybe Congress wasn't receiving full disclosure of some of the risks of some of the proposals that were being described and discussed over the last couple of weeks. In our written testimony, we try to describe what some of those risks might be.

I thank you for letting us incorporate that written testimony into the record. Today, I have been asked to talk about CFTC resources. I am happy to do that. I am happy to do that because as a regulator, I have some firsthand experience of just how difficult it is for a regulatory body to keep up with changes in an industry that changes as quickly and dramatically as the futures industry. I know it is difficult and I know it is even more difficult for the CFTC because they don't just oversee the intermediaries like we do. They oversee the markets as well. It is a difficult proposition.

It is even more difficult—and I think the most telling statistic I have seen over the last couple of weeks on this issue, is the fact that since the Commission opened its doors in 1974, trading volume on the exchanges has increased by 8,000 percent and during that same period of time, Commission staff has dropped by 12 percent. There is something about that picture that just isn't right. Now, regulators are like everybody else on God's green Earth. We are supposed to be able to do more with less because of technology and I know that is true.

But still at some point, there is just no substitute for people. I know that at NFA, for example, we are certainly a technology driven organization. But in the last 2 years alone, we have increased the size of our compliance department by 25 percent because of problems we were having in our neck of the woods. I know for a fact that over the last 5 years, the CFTC has been getting appropriations of about 80 percent of what it has been asking for. So it is a difficult situation to keep up with the industry under the best of circumstances. It is a whole lot harder when you can't get the resources that you need. I know Chairman Lukken has testified they could use an additional 100 people. I know, Congressman Etheridge, your bill calls for an emergency appropriation for the CFTC. What I am here to tell you is that NFA as a regulatory body is fully sympathetic with their situation and strongly supportive of any legislation that would get them the additional resources they need.

Mr. Chairman, I have mentioned that I have been here a number of times before. This is the first time I think I finished my testimony and the red light hasn't gone off. I have watched enough C–SPAN to say if I could, I yield back the balance of my time.

[The prepared statement of Mr. Roth follows:]

PREPARED STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CEO, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

My name is Daniel Roth, and I am President and Chief Executive Officer of National Futures Association. Thank you Chairman Peterson and Members of the Committee for this opportunity to appear here today to present our views on some of the proposals that have been introduced in recent weeks. NFA is the industry-wide self-regulatory organization for the U.S. futures industry. NFA is a not for profit organization, we do not operate any markets, we are not a trade association. Regulation and customer protection is all that we do. I should also point out that NFA does not regulate markets—we regulate the intermediaries that bring customers to those markets.

Our customer protection rules are all designed to ensure that customers have enough information to make fully informed investment decisions. That's why we prohibit our members from making wildly exaggerated claims of performance and why we require members to provide customers with full disclosure of all of the risks. I think full disclosure of risks is a good idea in Congress too, but as I have followed the debate here in recent weeks about how to deal with energy prices, I've seen a lot more wild claims than I have seen disclosure of risks.

I have seen a number of witnesses testify that Congress can reduce the price of energy by 50% within 30 days just by cracking down on futures markets. I have not heard even a shred of data or empirical information to support that claim, but it's interesting that once a third witness agrees with that proposition it moves from testimony to conventional wisdom to a God given truth with the speed of light. Other witnesses, including a Pulitzer Prize winning author and economic researcher, have cited extensive economic and geopolitical factors to caution against the fallacy of a quick fix. My point is that it is a lot easier to make wild claims than it is to back them up, and I appreciate this Committee's efforts to explore these issues in a careful, thoughtful manner. This is especially important since various proposals under consideration could have dire unintended consequences.

I should also point out that I usually view the "unintended consequences" argument with a fair degree of skepticism. It seems like every time we propose a new customer protection rule at NFA or propose customer protection legislation before this Committee, someone throws the "unintended consequences" argument at us. Usually, people are pretty vague about what those unintended consequences might be or why they might happen or why they would be so bad. That's not the case here. Various supposed quick fix solutions under consideration could have unintended consequences that are specific, foreseeable and very likely to do much more harm than good.

**Risky Business—Areas Where Congress Must Be Careful**

*Increasing Margins*

Take margins, for example. As I mentioned above, some have suggested that margins for energy futures contracts be raised to as high as 50%, with the prediction that with this simple stroke energy prices will fall by 50% within 30 days. Not so fast, please. First, we should recognize that in the futures industry margin is a performance bond designed to ensure that traders meet their financial obligations. Clearing organizations set margin levels with great care to cover the potential movement in the value of the futures contract in 1 day's trading. Used for its intended purpose, the margin setting process has been a huge success over the last 150 years in preventing defaults and insolvencies. Using margins to try to artificially lower the price of a futures contract is another thing altogether and could have the directly opposite result.

The apparent theory of these proposals is that index funds, pension funds and other institutional investors have predominantly long positions in the futures market that are driving energy prices up. These are precisely the investors, though, that have the deepest pockets and could easily meet any increased margin requirements. A dramatic increase in margins could be much more likely to drive more short positions from the market than longs. Fewer sellers with the same number of buyers means prices go higher, not lower. I do not know for sure that prices would go higher, but neither do you and neither do those that promise that energy prices will drop by 50%. That's the point. No one knows for sure and that's why there is risk. It is imperative that you recognize that risk, know that it is real, that it is substantial and know that you are being asked to roll the dice with the American economy.

We may not know for sure whether raising margins will cause energy prices to go up, but we do know for sure that it will not reduce trading activity—it will simply move it to off-shore or over-the-counter markets. The energy market is global and complex. Participants that seek to speculate can do so in centralized markets around the world or through over-the-counter transactions. Those investment decisions are based on numbers. If the cost of executing trades on regulated futures markets soars because of increased margins, those trades will simply move to a different market. And it's not just speculators that will be moving. Hedgers need liquid markets to manage their risks and they will go where the liquidity is, whether it's off-shore or off-exchange. The trading will still take place and the impact on prices will not diminish. The risk here is not a loss of profit for U.S. markets, it's a loss of transparency, of information, of regulatory authority. The notion that you can build a fence around this country to keep institutional, sophisticated market participants from trading the way they want to is simply detached from reality.

Finally, Congress should be aware that raising margins could increase systemic risk. No one knows with certainty whether increasing margins would cause a temporary drop in oil prices or drive prices higher. What we do know is that governmental actions would dramatically increase market volatility during a time when credit is tight, particularly in the U.S. No one can predict with certainty the consequences of such actions, but they would certainly subject the financial markets to turmoil and stress and a much greater risk of financial failures.

*Limiting Access to the Futures Markets*

Other proposals have been discussed that would either limit or completely block access to the futures markets for certain classes of investors. Completely apart from the question of whether Congress should, in effect, be making investment decisions for these market participants, hasty congressional action could again produce some very unattractive results. Many swaps dealers, including some of the most important banking institutions in the country, use futures markets to hedge the risk of their net exposure to their customers. Those customers may be speculating or may be commercial users that are hedging their own risks. When these swap dealers use futures markets to cover their exposure to their customers, they are generally not subject to speculative position limits and accountability levels because those firms are managing their risk. Some have suggested that these exemptions for swaps dealers should be eliminated, supposedly to reduce energy prices.

The CFTC has issued a special call for information to the largest swap dealers in the country to better understand the extent to which the customers of the swap dealers are engaging in speculative trading or commercial hedging transactions. Congress should not take any action regarding the swap dealers exemption until the CFTC has carefully and thoughtfully analyzed that information and reported its findings. Rash action at this time could limit the ability of both swap dealers and their commercial user clients to manage their risk at a time when risk management is more critical than ever. All too often in the recent past we have seen what hap-

pens when major firms fail to effectively manage their risk, with significant repercussions for the whole economy.

Others have proposed barring large pension funds from diversifying their portfolios by investing in agricultural and energy commodities. The health of their pension funds is critically important to literally millions of retirees. The health of their pension funds, in turn, depends on the ability of the fund managers to effectively diversify their portfolios. Barring pension funds from doing so by locking them out of certain markets makes no sense at all when retirees have to rely more and more on their pensions and less and less on Social Security.

**Things That Congress Should Do**

Obviously, the proposals discussed above each carry the substantial risk of making a very difficult situation much, much worse. Doing nothing, however, carries risks of its own. NFA strongly supports a number of proposals that would be constructive, positive steps.

*CFTC Resources*

CFTC staffing levels are at historical lows while trading volume is at historical highs. Something here is not right. It is always a struggle for a regulator to keep up with an ever changing market place, but that becomes harder and harder to do when you have fewer people on hand to do more work. NFA strongly supports proposals for emergency appropriations to the CFTC to hire more people and upgrade its technology.

As an aside, I know that regulators make convenient punching bags when bad things happen. That just comes with the territory. But the CFTC is an **independent** Federal agency, independent so that it can withstand external pressure from any source and try to do what is right. That's precisely what the CFTC has been doing throughout this process. In enhancing its information sharing agreements with FSA, working with Congress to close the Enron loophole in the farm bill, issuing its special call for information to major swaps dealers, forming an interagency task force to evaluate changes in commodity markets and undertaking revisions to its commitment of traders reports to improve transparency, the CFTC has worked tirelessly to do the right thing. The Commission has been hard at work in the enforcement area as well, bringing 39 actions involving energy markets alone and working with the Department of Justice on 35 criminal prosecutions involving energy market misconduct. I would like to recognize and applaud the CFTC's continuing efforts in this area.

*Foreign Boards of Trade*

The CFTC's recent agreement with ICE ensures that any exchange located in another jurisdiction that trades energy contracts with U.S. delivery points or that are linked to U.S. exchanges will provide the CFTC with the same type of information it gets from U.S. contract markets for surveillance purposes. We support proposals to codify that agreement. Drafting such legislation, though, can be a tricky business. The stroke of a bureaucrat's pen could change a foreign board of trade authorized to offer trading screens in the U.S. into an unregistered contract market. That could, in turn, make the positions held on that exchange illegal futures contracts, voidable at the customer's choice. Customers with losing positions could simply walk away, leaving an FCM holding the bag, and a very expensive bag at that. I know that others, including the FIA, are working on language to avoid that result and NFA supports those efforts.

*Commitment of Traders Report*

Transparency is everything in futures regulation. Congress should require the CFTC to enhance transparency in our markets by revising its monthly Commitment of Traders reports to ensure that trading by commercial users of the underlying commodity is listed separately from trading by index funds and hedge funds. The CFTC has indicated its intention to do so, but legislation to support that initiative would be helpful.

**Concluding Remarks**

In sum, Mr. Chairman, at NFA we constantly advise customers to beware of anyone that is selling a trading program guaranteed to produce dramatic profits with little or no risk. We offer the same advice to this Committee. The quick fix solutions currently being pitched to Congress carry with them substantial risks of unintended consequences that are real, that are foreseeable and that are potentially devastating. To enact these proposals would be to roll the dice on the American economy and would make the Congress of the United States the biggest speculator in our futures markets.

As always, we look forward to working with the Committee and would be happy to answer any questions.

The CHAIRMAN. Mr. Roth, we appreciate that very much. I want you to know that.

Mr. Slocum.

**STATEMENT OF TYSON SLOCUM, DIRECTOR, ENERGY PROGRAM, PUBLIC CITIZEN**

Mr. SLOCUM. Hi, my name is Tyson Slocum. I am Director of the Energy Program at Public Citizen. We are one of America's largest public interest consumer advocacy groups. I am speaking today on behalf of the 100,000 households who are dues paying members of my organization. Members of the Committee, thank you so much for the opportunity to testify today. I am going to be talking about an issue that has not unfortunately been touched on by a number of the other panelists and that is concerns that my organization has raised about potential anti-competitive relationships that exist between affiliates that own or control physical energy assets, like pipelines, storage facilities and energy trading affiliates.

Now, we all know that the number one issue in markets is access to information. If you have access to information, particularly important information before anyone else, whether that is hours before, minutes or even seconds before, you can parlay that access to information into huge gains, whether you are investing in the stock market or whether you are investing in commodities. We have noticed a trend of investment banks, hedge funds snapping up ownership over America's and North America's energy infrastructure assets; Goldman Sachs now owns an oil refinery. In 2006, Goldman Sachs completed the acquisition of over 40,000 miles of petroleum products and natural gas pipelines in North America.

We have all read about hedge funds and investment banks snapping up leasing rights over storage facilities. Now, why on Earth would investment banks and hedge funds invest money in relatively low return infrastructure assets like pipelines and storage facilities? It is because control over those assets provides them with enormous information advantages about products that are moving through that system or moving into storage. As we have discovered, there are little to no code of conduct rules governing communications between crude oil and petroleum product facilities and energy trading. This presents, in our opinion, a serious problem. I served as an expert witness in the State of California before the Public Utilities Commission challenging certain aspects of Goldman Sachs' acquisition of two petroleum product pipelines in the State of California. We raised the issue of wanting to erect firewalls, prohibiting communications between the California pipeline affiliates and Goldman's energy trading affiliates. It is important to note that Goldman at no time challenged our assertions by saying Public Citizen's proposal is redundant because we already have effective controls at the Federal level prohibiting this. That is because no effective controls exist. There are extensive code of conduct rules prohibiting such communications in the natural gas infrastructure industry, as headed by the Federal Energy Regulatory Commission. But they do not exist at the same level for crude oil and petroleum products.

There is unfortunately precedent for abuses within these types of relationships as last year's over $300 million settlement against the oil giant, BP, where BP was forced to pay over $300 million to settle allegations that it single handedly manipulated the United States propane markets by having its propane, pipeline and storage affiliates communicate with its energy traders. Those energy traders embarked on a strategy to corner the propane market. This strategy was not discovered because of the due diligence of America's regulatory environment. It was because an internal whistleblower discussed the practice of the company, exposed the scheme and took it to regulators who were able to force BP into the settlement.

And so, in addition to many of the other things about increasing transparency over markets, I urge the Committee to examine this fairly recent trend of large energy traders and speculators obtaining ownership control or effective control through temporary leasing rights over oil and petroleum product infrastructure. Thank you so much.

[The prepared statement of Mr. Slocum follows:]

PREPARED STATEMENT OF TYSON SLOCUM, DIRECTOR, ENERGY PROGRAM, PUBLIC CITIZEN, WASHINGTON, D.C.

Thank you, Mr. Chairman and Members of Committee on Agriculture for the opportunity to testify on the issue of energy futures regulation. My name is Tyson Slocum and I am Director of Public Citizen's Energy Program. Public Citizen is a 37 year old public interest organization with over 100,000 members nationwide. We represent the needs of households through research, public education and grassroots organizing.

American families are reeling under the weight of sustained high energy prices. Congress can take two broad actions to provide relief: providing incentives to households to give them better access to alternatives to our dependence on oil, and restoring transparency to the futures markets where energy prices are set. The former option is of course the best long-term investment, as providing incentives to help families afford the purchase of super fuel efficient hybrid or alternative fuel vehicles, solar panel installation, energy efficient improvements to the home and greater access to mass transit would all empower households to avoid the brunt of high energy prices.

But the second option—restoring transparency to the futures markets where energy prices are actually set—is also important. Stronger regulations over energy trading markets would reduce the level of speculation and limit the ability of commodity traders to engage in anti-competitive behavior that is contributing the record high prices Americans face.

Of course, supply and demand has played the primary role in the recent rise in oil prices. Although gasoline demand in America is down one percent from a year ago, global demand—particularly in emerging economies like China, India and oil exporting nations in the Middle East—has skyrocketed at a time when the mature, productive and easily-accessible oil fields are in decline. Claims of Saudi spare capacity are questioned due to the Kingdom's refusal to allow independent verification of the country's oil reserve claims. Simply put, oil is a finite resource with which the world has embarked on unprecedented increased demand.

But there is no question that speculators and unregulated energy traders have pushed prices far beyond the supply-demand fundamentals and into an era of a speculative bubble in oil markets. While some speculation plays a legitimate function for hedging and providing liquidity to the market, the exponential rise in market participants who have no physical delivery commitments has skyrocketed, from 37 percent of the open interest on the NYMEX West Texas Intermediate (WTI) contract in January 2000 to 71 percent in April 2008.[1]

Rather than demonize speculation generally, the goal is to address problems associated with recent Congressional and regulatory actions that deregulated energy trading markets that has opened the door to these harmful levels of speculation. Re-

[1] *http://energycommerce.house.gov/Investigations/EnergySpeculationBinder_062308/15.pdf.*

moving regulations has opened the door too wide for speculators and powerful financial interests to engage in anti-competitive or harmful speculative behavior that results in prices being higher than they would otherwise be (at least $30 of the current $140 of a barrel of oil—or about 70¢ of a gallon of gasoline—is pure speculation, unrelated to supply and demand.

While the Commodity Futures Trading Commission (CFTC) has taken recent small steps in the right direction—such as asking the United Kingdom to set limits on speculative trading of WTI contracts, proposing stronger disclosure for index traders and swap dealers, and proposing an interagency task force to more closely monitor energy markets—Congress must do more to protect consumers.

Public Citizen recommends four broad reforms to reign in speculators and help ensure that energy traders do not engage in anti-competitive behavior:

1. Increase the level of disclosure that market participants must submit to Federal regulators. Requiring investment banks, hedge funds and other market participants to provide more information to the government will provide regulators and policymakers with the data necessary to quickly determine the exact cause of price swings. Subjecting all energy traders to submit Large Trader Reports that discloses key information of a trader's activities is critical to ensure that a market is adequately transparent.

2. Raise margin requirements so market participants will have to put up more of their own capital in order to trade energy contracts. Currently, margin requirements are too low, which encourages speculators to more easily enter the market by borrowing, or leveraging, against their positions.

3. Require foreign-based exchanges that trade U.S. energy products to be subjected to full U.S. regulatory oversight.

4. Impose legally-binding firewalls to limit energy traders from speculating on information gleaned from the company's energy infrastructure affiliates or other such insider information, while at the same time allowing legitimate hedging operations. Congress must authorize the FTC and DOJ to place greater emphasis on evaluating anti-competitive practices that arise out of the nexus between control over hard assets like energy infrastructure and a firm's energy trading operations.

**Energy Trading Abuses Require Stronger Oversight**

Two regulatory lapses are enabling anti-competitive practices in energy trading markets where prices of energy are set. First, oil companies, investment banks and hedge funds are exploiting recently deregulated energy trading markets to manipulate energy prices. Second, energy traders are speculating on information gleaned from their own company's energy infrastructure affiliates, a type of legal "insider trading." These regulatory loopholes were born of inappropriate contacts between public officials and powerful energy companies and have resulted in more volatile and higher prices for consumers.

Contrary to some public opinion, oil prices are not set by the Organization of Petroleum Exporting Countries (OPEC); rather, they are determined by the actions of energy traders in markets. Historically, most crude oil has been purchased through either fixed-term contracts or on the "spot" market. There have been long-standing futures markets for crude oil, led by the New York Mercantile Exchange (NYMEX) and London's International Petroleum Exchange (which was acquired in 2001 by an Atlanta-based unregulated electronic exchange, ICE). NYMEX is a floor exchange regulated by the U.S. Commodity Futures Trading Commission (CFTC). The futures market has historically served to hedge risks against price volatility and for price discovery. Only a tiny fraction of futures trades result in the physical delivery of crude oil.

The CFTC enforces the Commodity Exchange Act, which gives the Commission authority to investigate and prosecute market manipulation.[2] But after a series of deregulation moves by the CFTC and Congress, the futures markets have been increasingly driven by the unregulated over-the-counter (OTC) market over the last few years. These electronic OTC markets have been serving more as pure speculative markets, rather than traditional volatility hedging or price discovery. And, importantly, this new speculative activity is occurring outside the regulatory jurisdiction of the CFTC.

[2] 7 U.S.C. §§ 9, 13b and 13(a)(2).

Energy trading markets were deregulated in two steps. First, in response to a petition by nine energy and financial companies, led by Enron,[3] on November 16, 1992, then-CFTC Chairwoman Wendy Gramm supported a rule change—later known as Rule 35—exempting certain energy trading contracts from the requirement that they be traded on a regulated exchange like NYMEX, thereby allowing companies like Enron and Goldman Sachs to begin trading energy futures between themselves outside regulated exchanges. Importantly, the new rule also exempted energy contracts from the anti-fraud provisions of the Commodity Exchange Act.[4] At the same time, Gramm initiated a proposed order granting a similar exemption to large commercial participants in various energy contracts that was later approved in April 2003.[5]

Enron had close ties to Wendy Gramm's husband, then-Texas Senator Phil Gramm. Of the nine companies writing letters of support for the rule change, Enron made by far the largest contributions to Phil Gramm's campaign fund at that time, giving $34,100.[6]

Wendy Gramm's decision was controversial. Then-Chairman of a House Agriculture Subcommittee with jurisdiction over the CFTC, Rep. Glen English, protested that Wendy Gramm's action prevented the CFTC from intervening in basic energy futures contracts disputes, even in cases of fraud, noting that that "in my 18 years in Congress [Gramm's motion to deregulate] is the most irresponsible decision I have come across." Sheila Bair, the CFTC Commissioner casting the lone dissenting vote, argued that deregulation of energy futures contracts "sets a dangerous precedent."[7] A U.S. General Accounting Office report issued a year later urged Congress to increase regulatory oversight over derivative contracts,[8] and a Congressional inquiry found that CFTC staff analysts and economists believed Gramm's hasty move prevented adequate policy review.[9]

Five weeks after pushing through the "Enron loophole," Wendy Gramm was asked by Kenneth Lay to serve on Enron's Board of Directors. When asked to comment about Gramm's nearly immediate retention by Enron, Lay called it "convoluted" to question the propriety of naming her to the Board.[10]

Congress followed Wendy Gramm's lead in deregulating energy trading *contracts* and moved to deregulate energy trading *exchanges* by exempting electronic exchanges, like those quickly set up by Enron, from regulatory oversight (as opposed to a traditional trading floor like NYMEX that remained regulated). Congress took this action during last-minute legislative maneuvering on behalf of Enron by former Texas GOP Senator Phil Gramm in the lame-duck Congress 2 days after the Supreme Court ruled in *Bush* v. *Gore*, buried in 712 pages of unrelated legislation.[11] As Public Citizen pointed out back in 2001,[12] this law deregulated OTC derivatives energy trading by "exempting" them from the Commodity Exchange Act, removing anti-fraud and anti-manipulation regulation over these derivatives markets and exempting "electronic" exchanges from CFTC regulatory oversight.

This deregulation law was passed against the explicit recommendations of a multi-agency review of derivatives markets. The November 1999 release of a report by the President's Working Group on Financial Markets—a multi-agency policy group with permanent standing composed at the time of Lawrence Summers, Secretary of the Treasury; Alan Greenspan, Chairman of the Federal Reserve; Arthur Levitt, Chairman of the Securities and Exchange Commission; and William Rainer, Chairman of the CFTC—concluded that energy trading must not be deregulated. The Group reasoned that "due to the characteristics of markets for nonfinancial commodities with finite supplies . . . the Working Group is unanimously recommending that the [regulatory] exclusion not be extended to agreements involving

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[3] The other eight companies were: BP, Coastal Corp (now El Paso Corp.) Conoco and Phillips (now ConocoPhillips), Goldman Sachs' J. Aron & Co, Koch Industries, Mobil (now ExxonMobil) and Phibro Energy (now a subsidiary of CitiGroup).

[4] 17 CFR Ch. 1, available at *www.access.gpo.gov/nara/cfr/waisidx_06/17cfr35_06.html.*

[5] "Exemption for Certain Contracts Involving Energy Products," 58 Fed. Reg. 6250 (1993).

[6] Charles Lewis, "The Buying of the President 1996," p. 153. The Center for Public Integrity.

[7] "Derivatives Trading Forward-Contract Fraud Exemption May be Reversed," *Inside FERC's Gas Market Report,* May 7, 1993.

[8] "Financial Derivatives: Actions Needed to Protect the Financial System," GGD–94–133, May 18, 1994, available at *http://archive.gao.gov/t2pbat3/151647.pdf.*

[9] Brent Walth and Jim Barnett, "A Web of Influence," *Portland Oregonian,* December 8, 1996.

[10] Jerry Knight, "Energy Firm Finds Ally, Director, in CFTC Ex-Chief," *Washington Post,* April 17, 1993.

[11] H.R. 5660, an amendment to H.R. 4577, which became Appendix E of P.L. 106–554 available at *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=106_cong_public_laws&docid=f:publ554.106.pdf.*

[12] *Blind Faith: How Deregulation and Enron's Influence Over Government Looted Billions from Americans,* available at *www.citizen.org/documents/Blind_Faith.pdf.*

such commodities."[13] In its 1999 lobbying disclosure form, Enron indicated that the "President's Working Group" was among its lobbying targets.[14]

As a result of the Commodity Futures Modernization Act, trading in lightly-regulated exchanges like NYMEX is declining as more capital flees to the completely unregulated OTC markets, such as those run by the IntercontinentalExchange (ICE). Trading on the ICE has skyrocketed, with the 138 million contracts traded in 2007 representing a 230 percent increase from 2005.[15] This explosion in unregulated trading volume means that more trading is done behind closed doors out of reach of Federal regulators, increasing the chances of oil companies and financial firms to engage in anti-competitive practices. The founding members of ICE include Goldman Sachs, BP, Shell and Totalfina Elf. In November 2005, ICE became a publicly traded corporation.

Goldman Sachs' trading unit, J. Aron, is one of the largest and most powerful energy traders in the United States, and commodities trading represents a significant source of revenue and profits for the company. Goldman Sachs' most recent 10–k filed with the U.S. Securities and Exchange Commission show that Fixed Income, Currency and Commodities (which includes energy trading) generated 35 percent of Goldman's $46 billion in revenue for 2007.[16] In 2005, Goldman Sachs and Morgan Stanley—the two companies are widely regarded as the largest energy traders in America—each reportedly earned about $1.5 billion in net revenue from energy trading. One of Goldman's star energy traders, John Bertuzzi, made as much as $20 million in 2005.[17]

In the summer of 2006, Goldman Sachs, which at the time operated the largest commodity index, GSCI, announced it was radically changing the index's weighting of gasoline futures, selling about $6 billion worth. As a direct result of this weighting change, Goldman Sachs unilaterally caused gasoline futures prices to fall nearly 10 percent.[18]

A recent bipartisan U.S. Senate investigation summed up the negative impacts on oil prices with this shift towards unregulated energy trading speculation:

> *Over the last few years, large financial institutions, hedge funds, pension funds, and other investment funds have been pouring billions of dollars into the energy commodity markets—perhaps as much as $60 billion in the* ***regulated*** *U.S. oil futures market alone . . . The large purchases of crude oil futures contracts by speculators have, in effect, created an additional demand for oil, driving up the price of oil to be delivered in the future in the same manner that additional demand for the immediate delivery of a physical barrel of oil drives up the price on the spot market . . . 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 . . . large speculative buying or selling of futures contracts can distort the market signals regarding supply and demand in the physical market or lead to excessive price volatility, either of which can cause a cascade of consequences detrimental to the overall economy . . . At the same time that there has been a huge influx of speculative dollars in energy commodities, the CFTC's ability to monitor the nature, extent, and effect of this speculation has been diminishing. Most significantly, there has been an explosion of trading of U.S. energy commodities on exchanges that are not regulated by the CFTC . . . in contrast to trades conducted on the NYMEX, traders on unregulated OTC electronic exchanges are not required to keep records or file Large Trader Reports with the CFTC, and these trades are exempt from routine CFTC oversights. In contrast to trades conducted on regulated futures exchanges, there is no limit on the number of contracts a speculator may hold on an unregulated OTC electronic exchange, no monitoring of trading by the exchange itself, and no reporting of the amount of outstanding contracts ("open interest") at the end of each day.*[19]

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[13] "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," Report of The President's Working Group on Financial Markets, p. 16. *www.ustreas.gov/press/releases/docs/otcact.pdf.*

[14] Senate Office of Public Records Lobbying Disclosure Database, available at *http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/1999/01/000/309/00030933130,* page 7.

[15] Available at *www.theice.com/exchange_volumes_2005.jhtml.*

[16] *www.sec.gov/Archives/edgar/data/886982/000095012308000857/y46519e10vk.htm.*

[17] *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf,* pages 24 and 26.

[18] Heather Timmons, "Change in Goldman Index Played Role in Gasoline Price Drop," *The New York Times,* September 30, 2006.

[19] *The Role Of Market Speculation In Rising Oil And Gas Prices: A Need To Put The Cop Back On The Beat,* Staff Report prepared by the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs of the U.S. Senate, June 27, 2006,

Thanks to the Commodity Futures Modernization Act, participants in these newly-deregulated energy trading markets are not required to file so-called Large Trader Reports, the records of all trades that NYMEX traders are required to report to the CFTC, along with daily price and volume information. These Large Trader Reports, together with the price and volume data, are the primary tools of the CFTC's regulatory regime: "The Commission's Large Trader information system is one of the cornerstones of our surveillance program and enables detection of concentrated and coordinated positions that might be used by one or more traders to attempt manipulation."[20] So the deregulation of OTC markets, by allowing traders to escape such basic information reporting, leave Federal regulators with no tools to routinely determine whether market manipulation is occurring in energy trading markets.

One result of the lack of transparency is the fact that even some traders don't know what's going on. A recent article described how:

> *Oil markets were rocked by a massive, almost instant surge in after-hours electronic trading 1 day last month, when prices for closely watched futures contracts jumped 8% . . . this spike stands out because it was unclear at the time what drove it. Two weeks later, it is still unclear. What is clear is that a rapid shift in the bulk of crude trading from the raucous trading floor of the New York Mercantile Exchange to anonymous computer screens is making it harder to nail down the cause of price moves . . . The initial jump "triggered more orders already set into the system, and with prices rising, people thought somebody must know something," Tom Bentz, an analyst and broker at BNP Paribas Futures in New York who was watching the screen at the time, said the day after the spike. "The more prices rose, the more it seemed somebody knew something."*[21]

Oil companies, investment banks and hedge funds are exploiting the lack of government oversight to price-gouge consumers and make billions of dollars in profits. These energy traders boast how they're price-gouging Americans, as a recent *Dow Jones* article makes clear: energy "traders who profited enormously on the supply crunch following Hurricane Katrina cashed out of the market ahead of the long weekend. 'There are traders who made so much money this week, they won't have to punch another ticket for the rest of this year,' said Addison Armstrong, manager of exchange-traded markets for TFS Energy Futures."[22]

The ability of Federal regulators to investigate market manipulation allegations even on the lightly-regulated exchanges like NYMEX is difficult, let alone the unregulated OTC market. For example, as of August 2006, the Department of Justice is still investigating allegations of gasoline futures manipulation that occurred *on a single day in 2002.*[23] If it takes the DOJ 4 years to investigate a single day's worth of market manipulation, clearly energy traders intent on price-gouging the public don't have much to fear.

That said, there have been some settlements for manipulation by large oil companies. In January 2006, the CFTC issued a civil penalty against Shell Oil for "noncompetitive transactions" in U.S. crude oil futures markets.[24] In March 2005, a Shell subsidiary agreed to pay $4 million to settle allegations it provided false information during a Federal investigation into market manipulation.[25] In August 2004, a Shell Oil subsidiary agreed to pay $7.8 million to settle allegations of energy market manipulation.[26] In July 2004, Shell agreed to pay $30 million to settle allega-

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available at *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf.*

[20] Letter from Reuben Jeffrey III, Chairman, CFTC, to Michigan Governor Jennifer Granholm, August 22, 2005.

[21] Matt Chambers, "Rise in Electronic Trading Adds Uncertainty to Oil," *The Wall Street Journal,* April 10, 2007.

[22] Leah McGrath Goodman, "Oil Futures, Gasoline In NY End Sharply Lower," September 2, 2005.

[23] John R. Wilke, Ann Davis and Chip Cummins, "BP Woes Deepen with New Probe," *The Wall Street Journal,* August 29, 2006.

[24] "U.S. Commodity Futures Trading Commission Assesses Penalties of $300,000 Against Shell-Related Companies and Trader in Settling Charges of Prearranging Crude Oil Trades" available at *www.cftc.gov/newsroom/enforcementpressreleases/2006/pr5150-06.html.*

[25] "Commission Accepts Settlement Resolving Investigation Of Coral Energy Resources," available at *www.ferc.gov/news/news-releases/2005/2005-1/03-03-05.asp.*

[26] "Order Approving Contested Settlement," available at *www.ferc.gov/whats-new/comm-meet/072804/E-60.pdf.*

tions it manipulated natural gas prices.[27] In October 2007, BP agreed to pay $303 million to settle allegations the company manipulated the propane market.[28] In September 2003, BP agreed to pay NYMEX $2.5 million to settle allegations the company engaged in improper crude oil trading, and in July 2003, BP agreed to pay $3 million to settle allegations it manipulated energy markets.[29]

In August 2007, Oil giant BP admitted in a filing to the Securities and Exchange Commission that "The U.S. Commodity Futures Trading Commission and the U.S. Department of Justice are currently investigating various aspects of BP's commodity trading activities, including crude oil trading and storage activities, in the U.S. since 1999, and have made various formal and informal requests for information."[30]

In August 2007, Marathon Oil agreed to pay $1 million to settle allegations the company manipulated the price of West Texas Intermediate crude oil.[31]

There is near-unanimous agreement among industry analysts that speculation is driving up oil and natural gas prices. Representative of these analyses is a May 2006 Citigroup report on the monthly average value of speculative positions in American commodity markets, which found that the value of speculative positions in oil and natural gas stood at $60 billion, forcing Citigroup to conclude that "we believe the hike in speculative positions has been a key driver for the latest surge in commodity prices."[32]

Natural gas markets are also victimized by these unregulated trading markets. Public Citizen has testified before Congress on this issue,[33] and a March 2006 report by four state attorneys general concludes that "natural gas commodity markets have exhibited erratic behavior and a massive increase in trading that contributes to both volatility and the upward trend in prices."[34]

While most industry analysts agree that the rise in speculation is fueling higher prices, there is one notable outlier: the Federal Government. In a widely dismissed report, the CFTC recently concluded that there was "no evidence of a link between price changes and MMT [managed money trader] positions" in the natural gas markets and "a significantly negative relationship between MMT positions and prices changes in the crude oil market."[35]

The CFTC study (and similar one performed by NYMEX) is flawed for numerous reasons, including the fact that the role of hedge funds and other speculators on long-term trading was *not* included in the analysis. *The New York Times* reported that "many traders have scoffed at the studies, saying that they focused only on certain months, missing price run-ups."[36]

The CFTC has a troublesome streak of "revolving door" appointments and hiring which may further hamper the ability of the agency to effectively regulate the energy trading industry. In August 2004, CFTC Chairman James Newsome left the Commission to accept a $1 million yearly salary as President of NYMEX, the world's largest energy futures marketplace. Just weeks later, Scott Parsons, the CFTC's Chief Operating Officer, resigned to become Executive Vice President for Government Affairs at the Managed Funds Association. Former CFTC Lead Prosecutor Tony Mansfi left the Commission to join the D.C. firm Heller Ehrman, where he will work for Geoff Aronow—his old boss at CFTC. Such prominent defections hamper the CFTC's ability to protect consumers. As a result, a revolving door moratorium must be established to limit CFTC decision makers from leaving the agency to go to entities under its regulatory jurisdiction for at least 2 years.

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[27] "Coral Energy Pays $30 Million to Settle U.S. Commodity Futures Trading Commission Charges of Attempted Manipulation and False Reporting," available at *www.cftc.gov/opa/enf04/opa4964-04.htm*

[28] *www.cftc.gov/newsroom/enforcementpressreleases/2007/pr5405-07.html.*

[29] "Order Approving Stipulation and Consent Agreement," 104 FERC ¶61,089, available at *http://elibrary.ferc.gov/idmws/common/opennat.asp?fileID=10414789.*

[30] *www.sec.gov/Archives/edgar/data/313807/000115697307001223/u53342-6k.htm*

[31] *www.cftc.gov/newsroom/enforcementpressreleases/2007/pr5366-07.html.*

[32] *The Role Of Market Speculation In Rising Oil And Gas Prices: A Need To Put The Cop Back On The Beat,* Staff Report prepared by the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs of the U.S. Senate, June 27, 2006, available at *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf.*

[33] "The Need for Stronger Regulation of U.S. Natural Gas Markets," available at *www.citizen.org/documents/Natural%20Gas%20Testimony.pdf.*

[34] *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral,* available at *www.ago.mo.gov/pdf/NaturalGasReport.pdf.*

[35] Michael S. Haigh, Jana Hranaiova and James A. Overdahl, "Price Dynamics, Price Discovery and Large Futures Trader Interactions in the Energy Complex," available at *www.cftc.gov/files/opa/press05/opacftc-managed-money-trader-study.pdf.*

[36] Alexei Barrionuevo and Simon Romero, "Energy Trading, Without a Certain 'E'," January 15, 2006.

**Latest Trading Trick: Energy Infrastructure Affiliate Abuses**

Energy traders like Goldman Sachs are investing and acquiring energy infrastructure assets because controlling pipelines and storage facilities affords their energy trading affiliates an "insider's peek" into the physical movements of energy products unavailable to other energy traders. Armed with this non-public data, a company like Goldman Sachs most certainly will open lines of communication between the affiliates operating pipelines and the affiliates making large bets on energy futures markets. Without strong firewalls prohibiting such communications, consumers would be susceptible to price-gouging by energy trading affiliates.

For example, In January 2007, Highbridge Capital Management, a hedge fund controlled by JP Morgan Chase, bought a stake in an energy unit of Louis Dreyfus Group to expand its oil and natural gas trading. Glenn Dubin, Co-Founder of Highbridge, said that owning physical energy assets like pipelines and storage facilities was crucial to investing in the business: "That gives you a very important information advantage. You're not just screen-trading financial products."[37]

Indeed, such an "information advantage" played a key role in allowing BP's energy traders to manipulate the entire U.S. propane market. In October 2007, the company paid $303 million to settle allegations that the company's energy trading affiliate used the company's huge control over transportation and storage to allow the energy trading affiliate to exploit information about energy moving through BP's infrastructure to manipulate the market.

BP's energy trading division, North America Gas & Power (NAGP), was actively communicating with the company's Natural Gas Liquids Business Unit (NGLBU), which handled the physical production, pipeline transportation and retail sales of propane. A PowerPoint exhibit to the civil complaint against BP details how the two divisions coordinated their manipulation strategy, which includes "assurance that [the] trading team has access to all information and optionality within [all of BP] . . . that can be used to increase chance of success [of market manipula tion] . . . Implement weekly meetings with Marketing & Logistics to review trading positions and share opportunities."[38]

And in August 2007, BP acknowledged that the Federal Government was investigating similar gaming techniques in the crude oil markets.

BP is not alone. A Morgan Stanley energy trader, Olav Refvik, "a key part of one of the most profitable energy-trading operations in the world . . . helped the bank dominate the heating oil market by locking up New Jersey storage tank farms adjacent to New York Harbor."[39] Again, control over physical infrastructure assets plays a key role in helping energy traders game the market.

This shows that the energy traders were actively engaging the physical infrastructure affiliates in an effort to glean information helpful for market manipulation strategies. And it is important to note that BP's market manipulation strategy was extremely aggressive and blatant, and regulators were tipped off to it by an internal whistle-blower. A more subtle manipulation effort could easily evade detection by Federal regulators, making it all the more important to establish firewalls between energy assets affiliates and energy trading affiliates to prevent any undue communication between the units.

Financial firms like hedge funds and investment banks that normally wouldn't bother purchasing low-profit investments like oil and gasoline storage have been snapping up ownership and/or leasing rights to these facilities mainly for the wealth of information that controlling energy infrastructure assets provides to help one's energy traders manipulate trading markets. *The Wall Street Journal* reported that financial speculators were snapping up leasing rights in Cushing, OK.[40]

In August 2006, Goldman Sachs, AIG and Carlyle/Riverstone announced the $22 billion acquisition of Kinder Morgan, Inc., which controls 43,000 miles of crude oil, refined products and natural gas pipelines, in addition to 150 storage terminals.

Prior to this huge purchase, Goldman Sachs had already assembled a long list of oil and gas investments. In 2005, Goldman Sachs and private equity firm Kelso & Co. bought a 112,000 barrels/day oil refinery in Kansas. In May 2004, Goldman spent $413 million to acquire royalty rights to more than 1,600 natural gas wells in Pennsylvania, West Virginia, Texas, Oklahoma and offshore Louisiana from Dominion Resources. Goldman Sachs owns a six percent stake in the 375 mile Iroquois

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[37] Saijel Kishan and Jenny Strasburg, "Highbridge Capital Buys Stake in Louis Dreyfus Unit," Bloomberg, January 8, 2007, *www.bloomberg.com/apps/news?pid=20601014&sid=aBnQy1botdFo.*

[38] *www.cftc.gov/files/enf/06orders/opa-bp-lessons-learned.pdf.*

[39] *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf,* page 26.

[40] Ann Davis, "Where Has All The Oil Gone?" October 6, 2007, Page A1.

natural gas pipeline, which runs from Northern New York through Connecticut to Long Island. In December 2005, Goldman and Carlyle/Riverstone together are investing $500 million in Cobalt International Energy, a new oil exploration firm run by former Unocal executives.

In 2003, Morgan Stanley teamed up with Apache Corp to buy 26 oil and gas fields from Shell for $500 million, of which Morgan Stanley put up $300 million in exchange for a portion of the production over the next 4 years, which it used to supplement its energy trading desk.[41]

**Conclusion**

This era of high energy prices isn't a simple case of supply and demand, as the evidence suggests that weak or non-existent regulatory oversight of energy trading markets provides opportunity for energy companies and financial institutions to price-gouge Americans. Forcing consumers suffering from inelastic demand to continue to pay high prices—in part fueled by uncompetitive actions—not only hurts consumers economically, but environmentally as well, as the oil companies and energy traders enjoying record profits are not investing those earnings into sustainable energy or alternatives to our addiction to oil. Reforms to strengthen regulatory oversight over America's energy trading markets are needed to restore true competition to America's oil and gas markets.

**Solutions**

- Re-regulate energy trading markets by subjecting OTC exchanges—including foreign-based exchanges trading U.S. energy products—to full compliance under the Commodity Exchange Act and mandate that all OTC energy trades adhere to the CFTC's Large Trader reporting requirements. In addition, regulations must be strengthened over existing lightly-regulated exchanges like NYMEX.
- Impose legally-binding firewalls to limit energy traders from speculating on information gleaned from the company's energy infrastructure affiliates or other such insider information, while at the same time allowing legitimate hedging operations. Congress must authorize the FTC and DOJ to place greater emphasis on evaluating anti-competitive practices that arise out of the nexus between control over hard assets like energy infrastructure and a firm's energy trading operations. Incorporating energy trading operations into anti-trust analysis must become standard practice for Federal regulatory and enforcement agencies to force more divestiture of assets in order to protect consumers from abuses.

The CHAIRMAN. Thank you, Mr. Slocum. And I would just share with you some of the issues that you have covered may be beyond the jurisdiction of this Committee. But that doesn't mean they shouldn't be looked at. Captain Prater.

## STATEMENT OF CAPT. JOHN PRATER, PRESIDENT, AIR LINE PILOTS ASSOCIATION, INTERNATIONAL, WASHINGTON, D.C.

Mr. PRATER. Good morning, Mr. Chairman, and Members of the Committee. As President of the Air Line Pilots Association, the largest airline pilot union in the world, I would like to thank you for the opportunity on behalf of our 55,000 members who fly for 40 airlines in the United States and Canada.

ALPA pilots do not declare Mayday at the first sign of a storm. We do not divert from our destination at the first sign of a snowflake. ALPA pilots, working with other industry workers, safely deliver passengers and cargo around our country and around the world every hour of every day. We help keep the economy running. In fact, the aviation industry alone generates $690 billion for America's bottom line and airline pilots play a pivotal role in that economic engine.

That said, our community is once again in an economic crisis that rivals the events that followed 9/11. Many airlines are in no

[41] Paul Merolli, "Two Morgan Stanley M&A deals show bullish stance on gas," *Natural Gas Week,* Volume 19; Issue 28, July 14, 2003.

position to handle the excessive jet fuel expenses that now cost more than anything else, exceeding labor and taxes by a wide margin. As a result of this burden, eight airlines have ceased operations this year. Two others have filed for Chapter 11 and several more are on the brink. Approximately 29,000 airline workers have lost their jobs this year and more will come this fall.

This hits pilots especially hard because they have already taken several economic blows to help save their airlines from the brink of extinction following 9/11. In the last 7 years, pilots have sacrificed pay, work rules, benefits and pensions to keep their airlines flying. Many of our members are still working under those concessions. They did this with the hope for the future that they would see their lost wages and their pensions returned. But with the rising cost of fuel, pilots are now more concerned than ever that their chosen profession is not one which will provide them with the compensation and retirement benefits that they need for their families.

Analysts forecast that airlines will lose as much as $10 billion this year. Continental, Delta, United, and Northwest have already announced further cuts in capacity and reductions in the workplace. Meanwhile, several other airlines are ready to announce. Nearly 30 small cities across our nation have already lost scheduled airline service and numerous larger cities are experiencing the cutbacks already. We will lose more transportation in this country.

Unlike other industries, which may have a choice of whatever type of energy to power its operations, the airliners that we fly have just one energy option, petroleum-based jet fuel. The FAA, the industry is working on alternatives to jet fuel, but it is going to take several years at best before a viable, renewable alternative meets the exacting specifications required to operate our jet engines safely.

We believe that rampant speculation in the oil commodities market is a serious situation that is negatively impacting the price of aviation fuel. ALPA, as part of a broad coalition with industry and business partners, has urged Congress for immediate reforms in the wildly speculative energy commodity futures markets. We fully support Representative Bart Stupak's PUMP Act, which would apply a much needed break on the surging oil prices that are crippling our industry and our economy. We would encourage any legislation that brings rationality to the oil markets.

The CFTC needs a nightstick if it helps to police speculators' trades in U.S. energy commodity markets. Unregulated swap trades and the so-called Enron loophole, among other weaknesses in the system, encourage speculators to trade U.S. energy supplies up to 20 times for each barrel of oil that is actually consumed. But with strong provisions that will bring over-the-counter energy commodities within CFTC's oversight, speculators will at long last be held accountable for their swaps.

The U.S. pilots who stand to lose their jobs due to the airlines going out of business are taking their skills abroad. We are starting to work for airlines overseas because the jobs aren't back home anymore. Many other young and old experienced pilots are leaving the industry altogether.

Simply put, in order for our industry to survive and continue to provide the world's safest transportation system, we must address this problem now. It is time to rein in rampant oil speculation.

In conclusion, a long-term, rational energy policy, including increased domestic supply and energy independence, is our ultimate goal, but bipartisan, near-term solutions to the market frenzy are critical now. We urge Congress to pass legislation before the August recess that will help rein in these rampant costs.

Thank you.

[The prepared statement of Capt. Prater follows:]

PREPARED STATEMENT OF CAPT. JOHN PRATER, PRESIDENT, AIR LINE PILOTS ASSOCIATION, INTERNATIONAL, WASHINGTON, D.C.

Good morning, Mr. Chairman, Ranking Member Goodlatte, and Members of the Committee. I am Captain John Prater, President of the Air Line Pilots Association, International (ALPA). ALPA represents nearly 55,000 professional pilots who fly for 40 passenger and all-cargo airlines in the United States and Canada. On behalf of our members, I want to thank you for the opportunity to testify today about the urgent need to address speculation in the fuel commodities market which we believe has contributed to the sharp jump in fuel prices that is greatly impacting our industry.

The rising cost of oil is of concern to everyone in this country today. Many are worried that they will be forced to choose between filling their automobile gas tanks and purchasing groceries, and we are already seeing the negative impact that the escalating price of oil is having on the economy. Our members—the working men and women safely flying our nation's airliners—have another, more dire concern: will they lose their jobs—again—because their airline is forced to park airplanes or even go out of business?

After the horrific terrorist attacks of 9/11, pilots and other employees in the airline business suffered through thousands of job furloughs and pay cuts. In fact, between 2002 and 2011, workers at the seven largest U.S. airlines have given back $75 billion in concessions. Almost $30 billion has come from pilots in the form of reduced wages, revised work rules, and reduced or eliminated benefits. Terminated pensions totaled another $5+ billion. A brief period of airline profits in 2007 promised some hope that these massive concessions which helped save the industry could be returned to workers and their families.

Instead, the recent rise in energy costs has caused a flood of red ink and analysts now forecast an industry operating loss of as much as $7 billion or more in 2008, one of the largest losses in the industry's history and rivaling that experienced shortly after the events of 9/11. The magnitude of this impact can already be seen in the recent bankruptcies and/or discontinued operations of ATA, Aloha, Champion, Skybus, Eos, Frontier, Skyway and Air Midwest. Other airlines have parked airplanes and either furloughed employees, or plan to do so in the near future.[1] This industry contraction is leading to the loss of thousands of skilled jobs and puts U.S. carriers at a disadvantage in the world marketplace. Ironically, the current industry fuel crisis also stifles progress to reduce fuel burn and emissions—at this time an unstable airline industry cannot afford to invest in new more fuel efficient aircraft[2] or invest in alternative fuel research.

A few salient facts about the current state of jet fuel expense, and industry reactions to that expense, help explain the airlines' predicament. Unlike many other industries which have a choice of electricity, natural gas, coal, heating oil or other sources of requisite energy, airlines have just one energy option for aircraft oper-

[1] **American Airlines** is reducing 4th qtr. 2008 mainline domestic capacity by 11–12% year-over-year. **Continental** is cutting 4th qtr. 2008 domestic capacity by 11.4% and reducing its workforce by 3,000. **Delta** is reducing its workforce by 3,000 and cutting 4th qtr. 2008 domestic capacity by 11%. **United** is cutting 4th qtr. 2008 domestic capacity by 14% and reducing the number of salaried employees by 1,400 to 1,600. Nearly 30 cities have lost scheduled airline service in the past year and more service cuts are on the horizon. **USAirways** is reducing mainline capacity 6–8% and reducing its workforce approximately 1,700. **Air Tran** cut employee salaries by 10% and many airlines are delaying starting new service because of fuel prices. This week, **Northwest** announced 2,500 job cuts.

[2] There are currently no major aircraft manufacturer plans to produce a next generation narrow body aircraft. We are at least a decade away from aircraft capable of significantly less fuel burn than our current fleet.

ations—petroleum-based jet fuel which must meet an exacting specification. Despite great technology-driven reductions in jet engine fuel consumption and airline pilot fuel conservation practices, jet fuel expenses have recently become the airlines' largest operating cost, now consuming as much as 40% of every airline revenue dollar, up from 15% in 2000. Jet fuel prices are expected to remain at extremely high levels; already increasing 67% from approximately $90.90 per barrel in 2007 to $151.72 per barrel in 2008. Every $1 increase in crude oil prices increases the industry's fuel expense by approximately $465 million, before considering the impact of any hedging. Because our carriers compete globally and fuel is priced in the weak U.S. dollar, our European counterparts have not experienced as dramatic of an increase in fuel costs, giving them a competitive advantage over the U.S. industry.

Airline pilots are working every day to conserve precious fuel during both ground and flight operations. Within the constraints of safety and hamstrung by an antiquated air traffic control system, pilots routinely shut down engines while taxiing and select optimal fuel-conservation altitudes and speeds. Further, pilots are working with the industry to help develop the NextGen air traffic management system that will further increase fuel efficiency. But all of those fuel-saving measures combined are incapable of compensating for the exorbitant fuel prices that we have experienced over the past year. No airline business plan can be successful with fuel topping $145 per barrel, and many will not survive in their present form at significantly less per barrel. Every day brings news of more airline worker layoffs, airplanes being grounded and air service to communities being cut. The U.S. aviation industry is a critical part of our national economy generating approximately 11% of Gross Domestic Product through airline travel and all related industries. Absent decisive and effective leadership on this issue, the airline industry's fortunes will continue to plummet and harm the national economy, in general, and airline workers, in particular, in the process.

Experts agree that today's surging oil prices are beyond those warranted by supply-demand fundamentals. In fact, just yesterday the International Energy Agency announced that annual demand is projected to increase at an annual rate of only 1.6% and that demand will be actually lower this year, growing only 1%, given declining economic conditions. Instead, surging oil prices are due, in some measure, to rampant investor speculation. In early June, speculators traded more than 1.9 billion barrels of crude oil—22 times the size of the physical oil market, including $150 billion traded on the New York Mercantile Exchange alone. Sophisticated "paper" speculators, including large pension fund managers, who never intend to use oil are driving up costs for consumers and making huge profits. This high amount of activity by "paper" speculators is having a grossly perverse impact on oil prices. Recently, ALPA and a broad coalition of consumer, labor, and business organizations joined to advocate immediate reforms in the widely-speculative energy commodity futures markets. While a long-term, rational energy policy including increased domestic supply and energy independence is our ultimate goal, bipartisan, near-term solutions to the market frenzy are absolutely critical.

With your leadership, we see an end to the current unwarranted escalation in oil prices which market speculation is helping to drive. ALPA has endorsed and pledged our support for the prompt enactment of Congressman Stupak's H.R. 6330, the "Prevent Unfair Manipulation of Prices Act of 2008." The PUMP Act will apply a much needed brake on rampant energy commodity speculation to help drive down unprecedented, surging oil prices that are crippling the economy. We are aware of several other proposed bills in both the House and Senate that share the same goal and we believe that they all have merit as a means of reducing the fuel speculation that is harming our industry.

The heart of the PUMP Act is Section 2 that extends CFTC jurisdiction over energy commodities that now enjoy a host of trading loopholes. The bill will open up the market to greater transparency and fairness to level the playing field for all traders by:

- bringing over-the-counter energy commodities within CFTC's oversight responsibilities;
- closing the "swaps loophole" by extending CFTC regulatory authority to swaps involving energy transactions, another important step towards needed transparency;
- extending CFTC regulatory authority to energy transactions on foreign boards of trade that provide for delivery points in the United States, a common sense measure as other products delivered in the United States are subject to the full panoply of United States regulation, save energy commodities; and

- requiring CFTC to set aggregate position limits on energy contracts for a trader over all markets, ensuring that traders do not corner markets by amassing huge positions and playing one exchange off another.

Unregulated swaps trades and the so-called "Enron loophole," among other weaknesses in the system, allow our most important energy supplies to be traded up to 20 times for each barrel of oil consumed. Why should oil future traders not have oversight similar to that of other security markets? Can we, as a nation, continue to stand idly by while speculators wreak havoc on our economy with the potential to destroy the air transportation links to many of our small and medium sized communities?

We strongly urge Congress to pass legislation to address the mostly unregulated futures trading of fuel before the August recess.

I thank you for the opportunity to testify today and look forward to your questions.

Mr. ETHERIDGE [presiding.] I thank the gentleman. I yield 5 minutes to the gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman. Thank you all for being here.

Mr. Slocum, that is the first time I have heard of what you described. Do your concerns go so far as to worry that the financial incentives could conceivably be so large, that someone holding the kind of interests in the actual underlying assets that control or produce the commodity could intentionally fool with those underlying assets in order to create a move in the market that could give it an awful lot of profit?

Mr. SLOCUM. Absolutely. And it is not just Public Citizen making that assertion. As part of the 2006 Senate Subcommittee on Permanent Investigations report, they provided information about how a single trader at Morgan Stanley was able to make huge successful bets in the futures markets based upon his company's acquisition of leasing rights over nearly all of the home heating oil storage facilities in New York Harbor, which obviously is a major import area. And this is something that the CFTC does have jurisdiction over.

BP admitted in a Securities and Exchange Commission filing in the summer of 2007 that the CFTC was looking into market manipulation related to BP's crude oil infrastructure assets and its energy trading division.

But the issue here is whether or not there is improper sharing of information that would not be captured under standard definitions of market manipulation.

Mr. MARSHALL. As a matter of fact, we have intentionally permitted individuals to trade on inside information in our futures markets because they serve such an important price discovery function for us. So not only do we not have a prohibition, it almost looks as if we encourage that kind of sharing.

Mr. SLOCUM. And there are absolutely legitimate reasons for owners of infrastructure assets, particularly large refiners that have to acquire crude oil. And they need to go out and hedge and participate in these markets. So there are legitimate functions for entities involved in energy infrastructure to be involved in the markets. The question, and this is where it is going to be tricky, is defining what is a legitimate hedging function and what is a speculative function and what decreases the level of competitiveness.

Mr. MARSHALL. Thank you, sir. In the limited amount of time I have, I want to move to a different subject. Mr. Roth, if we headed

in the direction of providing at least in ag commodities, no hedge exemption unless it is intended to cover a legitimate commercial—it is a legitimate commercial hedge and it is laying off risk from an actual physical market hedge that has occurred in the over-the-counter markets. We do that, we put in position limits and we direct the CFTC to put in position limits for energy that is similar to the position limits that exist for ag. And then with regard to all position limits, we say buy, buy these; if you don't and you are guilty of, directly or indirectly, intentionally circumventing these, you are liable for criminal penalties. Would that have any effect and——

Mr. ROTH. I think those are all viable options. They are serious ideas that I wouldn't rule out of hand at all. I would offer just the following quick observations.

With respect to position limits and again bearing in mind that I don't regulate markets, with respect to position limits, I understand how position limits work in a centralized marketplace because you can see everything. The imposition and implementation of position limits in a decentralized, bilateral sort of market like swaps are, would be a much more difficult thing to implement and monitor. It is not to say it can't be done, but I think you would have to think that through.

Mr. MARSHALL. You were here earlier, I noted. There is one possibility and it is the Lieberman aggregate position limits across all markets. There is another position limit simply in the futures markets that are regulated. Information provided across all markets to the regulator, to enable the regulator to see what people are doing and to see whether or not there is any circumvention of the position limits——

Mr. ROTH. I am just telling you monitoring compliance in a centralized market is one thing. Monitoring compliance in a decentralized, bilateral sort of series of agreements is a much more complex undertaking.

Mr. MARSHALL. Very challenging.

Mr. ROTH. The second point with respect to the swaps exemption, if I could. I think that is another idea that really needs to be explored, and that is why I was glad that the CFTC has made the special call for information, to really understand better what the underlying book of the swaps dealers is and what business they are turning to the futures market to hedge. The only danger that I see there is if we act now before we have the facts, before we have the results of that study, I think you want to be leery of doing anything that could limit the ability of either major financial institutions or their commercial users to manage their risk. So by all means, let us get the CFTC's data. Let us get it as quickly as we can and let us see if your option is warranted.

Mr. ETHERIDGE. I thank the gentleman very much. The gentleman from Texas, 5 minutes.

Mr. CONAWAY. Thank you, Mr. Chairman. Mr. Lynch and Captain Prater, you both paint some very stark pictures about the industries you represent and participate in. And speaking for somebody who is going to get on an airplane this afternoon and fly with a couple of your members, I am hoping they continue to do their job really well, at least until we get to the other end.

We have heard strong, committed, bright people on both sides of the issue in terms of what impact speculators are having. Our role is to try to figure out how that is happening. You did mention that your pilots are going overseas because there are jobs overseas. Is that because jet fuel is cheaper in Europe or Asia than it is here?

Mr. PRATER. Sir, the amount of concessions that we took following the 9/11 period has driven many people away from the job here in the U.S. The fact is a lot of people speak about prices and what goes into an airline ticket. We all know the major component is oil. If you fly on a flight this evening, maybe a 70 passenger jet and you are one of 70 passengers and you fly an hour, out of that ticket, about $1 will go to the captain and about 50¢ will go to the first officer. If you got on my airplane to fly to London, you would spend less than 75¢ an hour for my services, less than 50¢ an hour. So the jobs are better overseas.

Mr. CONAWAY. And that is because the airlines there charge more? I mean, the jet fuel prices are about the same there that they are here.

Mr. PRATER. Different economic systems possibly. Certainly we have a——

Mr. CONAWAY. But you are not aware that jet fuel is cheaper in Europe?

Mr. PRATER. No, I think that—while we know that the value of the dollar has played a part in this, I don't think that is the reason we are losing pilots here. The fact is pilots are getting out of the business because it just doesn't pay well.

Mr. CONAWAY. Sure. And that is kind of all of our opportunities as Americans. I do want to just briefly comment about Mr. Roth's plea to get the facts on the table first. We in Congress have a wonderful history of ready, fire, aim and the Chairman of this Committee, though, has attempted with these hearings to not let us run off that ledge. I want to also thank him for taking the time extensively. Other than the farm bill, these are the most extensive hearings we have had on a particular issue, and I appreciate his willingness to do that.

So I don't have any other questions, and I yield back.

The CHAIRMAN [presiding.] I thank the gentleman. The gentlelady from South Dakota.

Ms. HERSETH SANDLIN. Thank you, Mr. Chairman. Mr. Roth, I appreciated your response to Mr. Marshall's question about your thoughts on position limits and how they are easier or more difficult to administer in a certain context. I would be interested in your thoughts on the discussion of the prior panel on margin requirements. There are a number of us on this Committee that are concerned about unintended consequences with higher margin requirements, *versus* dealing with transparency, accountability and position limits as perhaps a different alternative to approach the issue.

Mr. ROTH. That is a real concern of ours, the margin issue. Because as I pointed out in my written testimony, that in our view, increasing the margins dramatically on energy products could have the effect of making prices higher rather than lower for the reasons that Mr. Duffy said that you could end up pushing more longs out of the market than shorts. And that will cause prices to go up. Mr.

Johnston's idea of increasing margins on the long only is essentially a market manipulation on the part of the Congress which is going to have a potentially disastrous effect on people that have taken margin positions.

In addition—I will just make two other points, one of which you have heard plenty of. If you increase margins on these U.S. markets, the business can go elsewhere. They can go OTC and they can go overseas and you really won't increase transparency or lower prices at all.

And then the final point that I would make is that a dramatic increase in margins is going to result in a lot of margin calls and it is going to result in defaults. It is going to put a certain amount of stress on futures commission merchants and clearing organizations. It is going to increase market volatility and therefore increase financial stress during a time of tight credit. Now we are talking about systemic risk, and no one knows where that might take you.

So the margin issue is a scary one for us because I think it has tremendous potential to do much greater harm than good.

Ms. HERSETH SANDLIN. I appreciate your comments there and the concerns about a systemic risk. I understand that you regulate the intermediaries, but certainly your familiarity with the issues with futures trading that the Committee has grappled with and dealt with for years, primarily in agricultural commodities. We have talked to folks in all of our districts who are individual producers, who have used grain merchandisers, elevator operators who are having problems with not being able to use the exchanges to hedge their risk in the manner that they used to be able to. How comfortable are you with a proposal like Mr. Etheridge's—and I appreciate your comments about the CFTC needing more resources and more staff. I couldn't agree with you more. Do you think that transparency, reporting, accountability and perhaps addressing position limits for institutional investors and those that were exempt, is that going to help alleviate the problems that individual producers or our grain elevator operators or petroleum marketers are facing?

Mr. ROTH. Any time you increase transparency, you give people more information and they can govern their conduct accordingly. You make it less likely that there can be a market manipulation, less likely that there will be a distortion of free market forces. I can't sit here and tell you that an increase in transparency—I think one of the claims is it would reduce the price of energy by 50 percent in 30 days. If a member of ours made a claim like that, we would expel him. I can't sit here and tell you that increase in transparency and all those things are going to drive down the price of energy dramatically. I can tell you that they would provide greater assurances of at least certain instances of market integrity.

Ms. HERSETH SANDLIN. Could you comment just briefly on Mr. Johnston's point in the last panel about how some of the passive longs have—there has sort of been an unwitting cornering of the market. I mean, what are your thoughts there?

Mr. ROTH. Again, recognizing that this is the deep end of the pool for me, too, and it is not what we regulate, the role of passive longs is a really interesting question. I would note that there are

certain commodities where there is a great deal of index participation where you have relatively flat prices. There are other commodities where there is virtually no index participation and you have huge fluctuations in prices. I know Mr. Johnston says they stay flat. I think Mr. Duffy is right. They roll over—they are always selling in the near month. And I would expect that if they are having a significant impact on prices, that you would see it in the near month as well as in the far month. I can't sit here and tell you I know what the impact of those index funds are, but what I can tell you, though, is this—and I am sorry. I will wrap this up as quickly as I can. In the time that I have been around, the only financial products that succeed—and I don't care if they are new futures contract, I don't care if they are some sort of exotic swaps contract that someone comes up with or an index fund, the only way any of these things ever succeed is if they are filling a market need. These index funds exist because people want exposure, they want that investment to those commodity prices, they want that exposure.

I can't conceive of a way to prevent them from doing that. If we try to foreclose their access to futures markets, that money will find another way to gain the exposure that they are looking for. I think transparency again, as I mentioned, always helps. It always helps ensure market integrity. But trying to put a jail offense around money and prohibiting money from being invested in a way that people want to invest it, I find that difficult.

Ms. HERSETH SANDLIN. Thank you. I thank the panel. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentlelady. The gentlelady from Kansas.

Mrs. BOYDA. Thank you very much, Mr. Chairman. I direct my comments to the truckers and to the airline association here, too, and just say again thank you for coming. Both industries are very, very important to Kansas, as you can well imagine. And the people who support you are people who you know, the good working people of Kansas. I feel your pain, let me just say that, and I hear about your pain on a regular basis. I appreciate your coming to Congress and asking for help.

What I would come back and ask you is what have you guys done? What I have heard in the last day—really 2 weeks—is for some reason the price of oil has tripled in the last year and a half, even though supply and demand really haven't changed, even though the dollar has gone down, but not anything that would affect a three-fold increase. What I have heard since the beginning of the spring was this drum beat that Democrats won't allow drilling. Have you ever recommended that you call your employees, your members and ask them to call oil companies, and I am truly asking you to do this. Were you in here during the earlier ones? Were you listening? There isn't a piece of equipment around. They have drilling capacity out the—they can drill and drill and drill. Could they be driving up the price of this? By just dealing with a constant fear in the marketplace and driving that? Why aren't they drilling? Call your Member of Congress for sure. Have you ever tried calling the oil companies and saying why don't you have any equipment, why aren't you drilling. As I said, there is more oil in

the Alaskan oil preserve, National Petroleum Reserve than there is in the ANWR, and they have the ability to drill on it today. What is going on? It is accessible oil. I said over and over again, "Public policy follows public opinion." And public opinion, I think people are beginning to understand now that the Governors of Florida happen to be Republicans for years and years and years and said, "Over my dead body am I going to let you drill off of here," and the same in California. Is it possible that your lives are being wrecked—the lives of your members are being wrecked for political gain here?

Now, we have one of two things going on. We have inexplicable change in the marketplace that just started to happen this spring. Or we have speculation and what we are left trying to figure out is which one of those it is that.

Mr. LYNCH. I will take a stab at that. There is a very good reason why I am on the miscellaneous panel. There are things that we know and there are things that we don't know. When the crisis really started to build, we were directed by our board to come up and look at a very comprehensive set of solutions, what can we do. Some of those involved supply, some of them quite frankly involved demand. I would suggest it is not a healthy thing to go to the Kansas Motor Truck Association and recommend that they adopt a 65 mile per hour speed limit in the State of Kansas, nor in a lot of other places. But yet we are doing that. I mean, we are trying to encourage our membership to do the kinds of things——

Mrs. BOYDA. And I saw the position that you took on that. I do not support it one way or the other. I think we should have a national debate about it. Why it is not even being discussed is bizarre. But you all took a strong position on that, and that is gutsy.

Mr. LYNCH. We are learning an awful lot about the ins and outs of the petroleum markets. We have had meetings with API. We have had meetings with the CFTC. Frankly, 2 years ago, I couldn't have told you where the CFTC's building was and yet we have gone down there to learn so that we don't step out too far.

Mrs. BOYDA. Let me reclaim my time with just about half a minute left. I would ask you to ask your members or to do your own homework and come up with why all of a sudden this is going on. Is somebody trying to manipulate a market that is ultimately really, really hurting you. I would ask the same thing of you, too, and say call your Member of Congress. But let us find out. Let us get to the bottom of why the supply—there isn't anyone on either side of the aisle that says we shouldn't increase supply. So let us increase supply, let us go back and I think if API began to understand that at the grassroots level, people are going to be calling them and saying, what the heck are you doing, you will start to see some things change and then we will start to see if this is speculation or if another message gets out that the American people are going to demand. You have the capacity right now to drill. Why the heck aren't you using it? Maybe that will take the edge off of this kind of irrational exuberance that is going on in that market and start to mediate it.

I apologize for interrupting you. I yield back.

The CHAIRMAN. I thank the gentlelady. The gentleman from Wisconsin.

Mr. KAGEN. Thank you, Mr. Chairman. Mr. Slocum, on page 7 of your prepared statement, I want to read a sentence and see if you still agree with it. "Oil companies, investment banks and hedge funds are exploiting the lack of government oversight to price gouge consumers and make billions of dollars in profits."

You go on to identify that Shell Oil, British Petroleum, and Marathon Oil have paid millions of dollars in fines for violations of marketplace rules that the CFTC had brought them to some form of justice. You then also quote that in 2006 Citicorp concluded, "we believe the hike in speculative positions has been a key driver for the latest surge in commodity prices."

Then you identify several individuals who went through a revolving door between the oil industry and the CFTC itself. So I guess my question comes, you are questioning, really aren't you, whether there is a cop on the beat and whether or not there is anyone minding the store. Could you please amplify in that regard?

Mr. SLOCUM. That is correct, we have long held a position that we do not have adequate disclosure requirements or transparency over these key markets. I began my statement by talking about how information is the key driver in markets. I think that it is bad policy for government regulators who are in charge of protecting households, my constituents as a representative of one of America's largest consumer groups, the government lacks access to the key data to understand what is driving these fluctuations in the marketplace.

We always hear about the supply and demand, and everyone has acknowledged that a large segment of the energy trading goes on outside of the jurisdiction of Federal regulators. We have seen that in the cases where the government does have regulatory jurisdiction that they have caught very large, very sophisticated oil companies in market manipulation strategies. If market manipulation strategies are even occurring on regulated exchanges, we can only imagine what is going on on exchanges that are free from regulatory oversight.

Mr. KAGEN. Well, if you haven't had time, the opportunity to review some of the bills that are moving through this House and this Committee, I would appreciate if you would do so. Bart Stupak has a bill on the Energy Commerce side on the PUMP Act or PUMP Act II, as he sometimes refers to it. Mr. Etheridge has a bill that is moving forward. Do you think any of these measures will put a cop back on the beat and make certain that consumers have someone on their side of the equation?

Mr. SLOCUM. Yes, absolutely. I testified before Representative Stupak's Committee last year where we talked about Public Citizen's concerns with regulation of markets. I believe that Representative Stupak's bill will be a great step in restoring some transparency.

I do not believe some of the, to put it mildly, hysterical language that is coming out of some of the large energy traders, like Goldman Sachs. I just read today in *The Wall Street Journal* that Goldman Sachs is running around Congress trying to warn Congress not to tighten regulations over these markets. Well, of course Goldman Sachs is going to say that because they have massive financial interest in continuing to earn record profits off of under-regulated

and nontransparent markets. That it might be great for the bottom line of Goldman Sachs and its shareholders and its top executives, but as folks on this panel have testified and others, and I am sure your constituents are saying, it is wrecking the American economy and causing great harm.

And are oil prices high because of supply and demand? Yes. But I believe that speculation is adding insult to injury to these high prices and that there clearly is a disconnect between the supply/demand fundamentals and the current record high prices and a lot of that is due to the door being wide open to the ability of speculators. Whether that is——

Mr. KAGEN. I don't mean to cut you off, but Mr. Roth, do you have some comments about this, you have some history here.

Mr. ROTH. Just a point of clarification, the CFTC has and has exercised authority to prevent manipulation on commodities traded on futures exchanges. Even when the manipulative conduct occurred off-exchange. There have been any number of cases where the Commission has brought manipulation cases, where the activity involved occurred off-exchange but had an effect on-exchange. So to suggest that there is no cop on the beat to guard against that type of manipulation of those futures exchanges is just incorrect.

Mr. KAGEN. Would it be more correct to say there is a slow cop on the beat because that litigation may take years to take effect and they have not been put in jail?

Mr. ROTH. I would suggest that those cases are, by their nature, incredibly complex. You don't bring a market manipulation case over a weekend. There are, in fact, intensive investigations. And as long as we have due process, it will take a while.

Mr. KAGEN. The same question to you, Mr. Roth, begging the Chairman's indulgence. Do you have an opinion as to the Stupak bill, the Etheridge bill or any other bill that is before the House that might help to remedy this situation?

Mr. ROTH. We are strongly supportive of this, Congressman. In Mr. Etheridge's bill there are provisions with respect to the codification of the CFTC's action to close the so-called London loophole that needs drafting work. I am sensitive to some concerns on that.

With respect to Congressman Stupak's bill, I believe there are positions in his bill that have to do with margins. And I would be against any sort of precipitous action with respect to the swaps exemption until we get further information.

Mr. KAGEN. I appreciate your input and yield back my time.

The CHAIRMAN. I thank the panel for sharing their expertise and time with us; we appreciate it. With that, we have concluded the hearing. Everybody, I appreciate you being here. Do you have anything to say before we adjourn?

Mr. CONWAY. Thank you for having the hearings, they are productive and there are great people on both sides of the issue.

The CHAIRMAN. Thank you. Under the rules of Committee, the record of today's hearing will remain open for 10 days to receive additional material and supplementary written responses; this will also apply to the two previous days' hearings as well, written responses from the witnesses to any question posed by a Member to the panel. This hearing of the Committee on agriculture is hereby adjourned.

[Whereupon, at 12:15 p.m., the Committee was adjourned.]

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