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HEARING TO REVIEW DRAMATIC MOVEMENTS IN AGRICULTURE AND ENERGY COMMODITY MARKETS

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

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HEARING TO REVIEW DRAMATIC MOVEMENTS IN AGRICULTURE AND ENERGY COMMODITY MARKETS

THURSDAY, SEPTEMBER 11, 2008

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

The Committee met, pursuant to call, at 1:04 p.m., in Room 1300, Longworth House Office Building, Hon. Tim Holden [Vice Chairman of the Committee] presiding.

Members present: Representatives Holden, Etheridge, Baca, Scott, Marshall, Cuellar, Boyda, Space, Gillibrand, Kagen, Pomeroy, Barrow, Goodlatte, Lucas, Moran, Rogers, Neugebauer, Kuhl, Foxx, Conaway, Smith, Walberg, and Latta.

Staff present: Adam Durand, Alejandra Gonzalez-Arias, Scott Kuschmider, Rob Larew, Clark Ogilvie, John Riley, Bryan Dierlam, Tamara Hinton, Kevin Kramp, and Jamie Weyer.

OPENING STATEMENT OF HON. TIM HOLDEN, A REPRESENTATIVE IN CONGRESS FROM PENNSYLVANIA

Mr. HOLDEN. The meeting will come to order. I think everyone is aware that the Chairman's mother has passed away so the Chairman is in Minnesota today. The funeral is today. So I think it is appropriate now if we would ask everyone to please stand for a moment of silence.

The Chairman thought it was very important that we move forward with this hearing even under the circumstances. So at this time, I would like to turn over the gavel to the Chairman of the Subcommittee on General Farm Commodities and Risk Management, the gentleman from North Carolina, Mr. Etheridge.

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

Mr. ETHERIDGE [presiding.] I thank the gentleman. And let me welcome all of our guests here today. And I thank you, Mr. Holden. And I would like to echo your sentiments with regards to our thoughts and prayers being with the Chairman today because, having lost my mother recently, I know it is a very difficult time.

As everyone knows, for the past several months the Members of this Committee have been taking a hard look at the commodity markets and energy and agriculture in response to concerns that excessive speculation may be having an undue impact on commodity prices. We have held several hearings and produced legisla-

tion in this area: H.R. 6604, the Commodity Markets Transparency and Accountability Act of 2008, introduced by Chairman Peterson and myself, that was considered on the House floor.

In May of this year the Commodity Futures Trading Commission announced an effort to obtain detailed information concerning over-the-counter trading and physical commodities in order to get a clear look at index trading in commodities and its impacts on markets, as well as to review the activities of swap dealers in these markets. While others have tried to get a handle on speculation on the level of trading and impact of these market participants, the CFTC in its report that it will present today has hard data regarding trading activities of these market participants. As such, it should provide the most accurate look at index trading and swap dealer participation in the OTC market.

I know Chairman Peterson wanted to wait for the results of this report before moving forward with legislation. But now we will have the benefit of this information before we return to consideration of commodity futures legislation.

Since our bill was considered by the full House, much has happened that raises additional questions. Oil prices have dropped considerably, the CFTC announced a reclassification of trades from commercial to noncommercial in its Commitments of Traders report. While this report covers information from January through June of this year, I also know that the CFTC continues to collect this OTC data and has information for July and August.

I hope, Chairman Lukken, either during your oral presentation or during the Q&A, you can talk about what the data you have collected for July and August says when prices fell and what it has to show us or tell us.

I also expect you will get questions about reclassification of certain trading from commercial to noncommercial. While all of us are glad to see the price of oil decline in recent months, it does not relieve the Commission, this Committee, or Congress of our responsibility to make sure that commodity markets are operating effectively, efficiently and fairly. To that extent I look forward to hearing today's testimony.

[The prepared statement of Mr. Etheridge follows:]

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

Thank you Mr. Holden, and I echo your sentiments with regard to our thoughts and prayers being with Chairman Peterson today. I want to thank everyone for joining us today.

As everyone knows, for the past several months the Members of this Committee have been taking a hard look at commodity markets in energy and agriculture in response to concerns that excessive speculation may be having an undue impact on commodity prices.

We held several hearings and produced legislation in this area, H.R. 6604, the Commodity Markets Transparency and Accountability Act of 2008 introduced by the Chairman and myself, that was considered on the House floor.

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While all of us are glad to see the price of oil decline in recent months, it does not relieve the Commission, this Committee or Congress of our responsibility to make sure that commodity markets are operating effectively, efficiently, and fairly. To that extent, I look forward to hearing today's testimony.

Before I turn to our witness, I now turn to the gentleman from Virginia, the Ranking Member, Mr. Goodlatte for his opening statement.

Mr. ETHERIDGE. But before I turn to our witnesses, I now turn to the gentleman from Virginia, the Ranking Member, Mr. Goodlatte, for his opening statement.

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

Mr. GOODLATTE. Thank you. And I want to start by thanking you and Chairman Peterson not only for calling this hearing today, but for working on this issue in a very bipartisan way. It has involved many Members on both sides of the aisle in making sure that we proceed to examine the issues carefully. But, also to do it in a manner that does not cause us to do something precipitous that could affect the markets in ways that would be detrimental to both the producers and consumers of energy and agricultural commodities.

This is part of a series of hearings this Committee has called, to learn more about the nature of our present-day commodity markets and whether or not activity on those markets is unjustly influencing the price of oil. I commend this Committee for taking a proactive approach to try to understand and monitor this issue and conduct appropriate oversight so that we can make an informed decision about whether or not commodity markets need greater transparency and accountability.

Today we will hear from the CFTC's Chairman Walt Lukken. Mr. Lukken and his staff have spent a lot of hours and a great deal of work over the past 3 months to produce a report on the futures markets. We appreciate their efforts, especially for keeping to an aggressive timetable to produce a report that will be useful to this Committee. We hope this report will be a reference point in determining the role index fund-related activity in the OTC markets and commodity futures has played, if any, in the recent rapid increase in energy and agricultural prices in the United States.

However, as we move forward today, it is important to remember the implications of our actions on both the energy and agricultural markets. We must resist measures that may have an impact on one

class of commodities at the expense of others. Such actions can and will directly impact the livelihood of our agricultural producers.

Also, it is supremely important to note that the findings of this report and the legislation that stems from it will not reduce the price of oil. It will not relieve the burden many Americans face at the gas pump. In order to achieve that very important goal, Congress must focus on creating a strong energy policy that, above all else, increases the domestic supply of all energy sources and promotes energy independence.

Mr. Chairman, I look forward to and welcome the testimony of our witness today, and again regret that the Chairman could not be with us because of the unfortunate passing of his mother. And our prayers go out to him and his father and the rest of his family. And we hope that they will find relief and that all of the blessings that his family has enjoyed from their mother will live with them and the grief will pass. Thank you Mr. Chairman.

Mr. ETHERIDGE. I thank the gentleman. And I was going to recognize my friend Mr. Moran, but he is not here. The chair would request that other Members submit their opening statements for the record so the witness may begin his testimony and that we may ensure that we will have adequate time for questions, given that we may have—and let me just say we may have some floor votes coming up this afternoon. Mr. Chairman, if we do, we will take appropriate action to that.

[The prepared statements of Mr. Peterson and Mr. Everett follow:]

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

I want to thank my friend and colleague, General Farm Commodities and Risk Management Subcommittee Chairman Bob Etheridge, for holding today's important hearing in my absence.

The purpose of today's hearing is to hear from the Commodity Futures Trading Commission (CFTC), the chief regulator of U.S. futures markets, about the continued volatility in the markets for energy and agricultural commodities. CFTC is here today to release a report that is expected to provide fresh data to help answer questions about the amount of index fund participation and the depth of financial speculation in these markets, which are questions this Committee has been asking for several months in the wake of record commodity prices.

Since this Committee last met, further interest in this issue has been raised because of the rapid decrease in crude oil futures and other commodity prices, raising the possibility that a mass sell-off by large speculators in these markets triggered the price decline. In addition, recent news reports about CFTC's reclassification of certain traders have sparked debate about swap dealer activity and whether all swap dealers are engaged in speculative trading.

There is already sufficient evidence that pensions, endowments, and other long-term investors are playing a bigger role in futures markets by investing in a broad mix of commodities as a way to diversify their holdings and reduce volatility and risk. Instead of directly purchasing futures contracts, much of this investment comes through large institutional swap dealers through an over-the-counter commodity index contract. The chain of transactions that swap dealers make in order to reduce their own exposure to commodity price risk has made it difficult for regulators to determine the total amount of index trading occurring in the energy markets.

In order to better understand the extent and possible impact of index trading, the Commission issued special calls to swap dealers requiring them to provide information on commodity index trading. Having analyzed this data, the Commission and its staff are here today to report to Congress regarding the scope of commodity index trading in the futures markets and, should they be necessary, recommendations for administrative and legislative action.

I would also like to hear about CFTC's July reclassification moving certain swap dealer positions in the crude oil market from commercial to noncommercial. The reclassification of a single large trader meant that noncommercial traders comprised about half of the open interest in West Texas Intermediate crude oil futures and options on the New York Mercantile Exchange. This new data showed that market speculators may have been more involved in the crude oil market than previously thought, while raising new questions about the CFTC's methods in classifying speculators and commercial hedgers.

I also look forward to a continued discussion with CFTC about H.R. 6604 in light of this new information. H.R. 6604 is a bipartisan bill that passed the House Agriculture Committee earlier this year by voice vote and would strengthen oversight of the commodity and futures markets for energy and agricultural commodities. Among its provisions to promote increased transparency in these markets are the codification of CFTC's recommendations in examining the true extent of index and other passive fund participation.

CFTC's report on index trader classification will assist this Committee and this Congress greatly in examining speculator participation in futures markets as we continue moving forward on a bipartisan, consensus solution to improve transparency and restore confidence in our futures markets.

PREPARED STATEMENT OF HON. TERRY EVERETT, A REPRESENTATIVE IN CONGRESS FROM ALABAMA

Thank you Chairman Peterson. I would also like to thank Acting Chairman Walter Lukken of the Commodity Futures Trading Commission for coming before the Committee again today to update us on what his agency has found in their report regarding swap dealers.

As energy prices have remained high in the United States this summer, Americans are extremely concerned and angry. As we know, the increase cost of fuel is related to growth in global demand—particularly in countries like India and China, need for more production, and the need for more refinery capacity in the United States. Additionally, there is a question on whether the increasing activities of energy being sold on the commodity market may be having a significant influence on the rise of prices for commodities like crude oil or natural gas.

Why is this a concern? The increased cost of energy is not only being seen at the gas pump or our electric bills, but in the cost of groceries and other goods. Additionally, there is a concern over the future of American's safety net due to the vast amounts of money that are flowing into the futures market that are linked to pensions, endowments and other long-term investors. And when the American people see the cost of crude oil shooting up $11 in 1 day, some are beginning to question whether the trading market is contributing to the high cost of fuels. Whether this is just coming from American's skepticism of trading and fear or based on some real concerns is still unclear.

Over the last few years, the futures market has grown over 500 percent and is done with little transparency. Due to the change of the nature of the market and the drastic increases in the trading of fuels, it is important that we ensure that the appropriate safeguards are in place and there is transparency in the market to prevent any manipulation.

I am pleased that Chairman Lukken was able to keep his promise to the Committee in reporting back to Congress on the results of CFTC's investigation this summer. I understand this must have been a difficult thing to accomplish with historically low number of staff. I thank you and your staff for the hard work.

This study and any further action taken by Congress regarding commodity future trades is critical to the stabilization of the market. I understand that you will suggest to the Committee that we need to re-evaluate classifications of some of the dealers, develop additional reporting and more accurate assessment of activities, and re-evaluate some of the existing exemptions. I look forward to your testimony in pointing out what impact these changes would have on the markets and would any of these provisions had prevented the high price of fuel if they were already in place.

Chairman Lukken, I do hope that you will also discuss the report that was released this week by Michael Masters that has been receiving significant press coverage. I believe his report is claiming that the fall in oil prices this summer was the result of excessive speculation playing a role in the rise of oil earlier this year. In recent weeks, we have seen that investors have pulled over $39 billion out of the commodity markets. At the same time, we have seen prices of gas going from above $4.00 and dropping to prices around $3.60 in various parts of the country. Of course

other factors such as changes in the demand by consumers, increase production, and increase value of the dollar may have had some influence in the decline and may also be the reason why the price is still as high as they are today. However, if the results of this report are accurate, it does seem to suggest that the market may be influencing commodity prices to some extent. I am interested in hearing what the recommendations offered today would do to address these claims.

I look forward to Chairman Lukken's testimony as well as his answers to many of our questions about what is needed to ensure the American people that markets are not artificially inflating the cost of fuel.

Mr. ETHERIDGE. We would also remind you that your full testimony will be entered into the record, and if you would be willing to summarize it. I would like to welcome you today. Chairman Lukken who is the Acting Chairman of the Commodity Futures Trading Commission and also acknowledge the presence of Commissioner Sommers who is with us also. Thank you. And, Mr. Lukken, please begin when you are ready.

STATEMENT OF HON. WALTER LUKKEN, ACTING CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Mr. LUKKEN. Thank you Chairman Etheridge, Ranking Member Goodlatte, and other distinguished Members here today, for inviting me to testify regarding the Commission's recent review of the trading activities of swap dealers.

One of the core missions of the CFTC is protecting the sanctity of the central price discovery process on futures exchanges. If prices are not reflecting fundamentals of supply and demand, the futures markets are not functioning properly and all Americans suffer.

With the growth of electronic trading, globalization and financial innovation, we have witnessed the development of satellite financial markets that complement and compete with the centralized and regulated futures markets in the United States. During the last year, the CFTC has systematically been reviewing these developments to determine whether these satellites are having an impact on the centralized price discovery process and to make regulatory adjustments as needed.

As you know, a combination of Congressional and Commission action has resulted in increased regulation of trading on exempt commercial markets and increased transparency in reporting of trading on foreign boards of trade that seek access to trade contracts linked to any U.S. contract markets. More recently, we have been reviewing the role of swap dealers and index traders and whether their connection to the futures markets is having an impact on the price of commodities.

In May, the CFTC announced that it would use its special call authority to gather new detailed data from swap dealers on the amount of index trading occurring in the over-the-counter markets. The CFTC staff has collected and analyzed an unprecedented data set. And today I am pleased to present the CFTC staff report with Commission recommendations. I would note that Commissioner Chilton dissented from the Commission recommendations, which is included in our final report.

Although this has proven to be a huge undertaking for our staff and the agency, it is a critical endeavor to ensure that our markets

are functioning properly. The special call was intended to capture all commodity index trading activity for month-end dates beginning December 31, 2007 through June 30, 2008, and continuing thereafter.

While the preliminary survey results represent the best data currently available on swap dealers and commodity index traders, there are limitations to the data due to time and resource constraints and the complexity and amount of data received.

With that in mind, the CFTC staff report found that on June 30, 2008, the last snapshot we looked at, the total net amount of commodity index trading, both over-the-counter and on-exchange, stood at $200 billion. Of this amount $161 billion was tied to commodities traded on U.S. markets regulated by the CFTC. Although a sizable amount of this $161 billion figure may not reach the futures markets due to internal netting by swap dealers, to put that number in context, it represents about 17 percent of the roughly $1 trillion of notional value for those same commodities traded on-exchange.

To determine whether this increase in notional amounts was due to commodity price appreciation or increases in new swap positions, staff analyzed certain key index commodities including crude oil, corn, wheat, and cotton. For NYMEX crude oil, the net notional amount of commodity index investment rose from about $39 billion in December to around $51 billion in June, an increase of more than 30 percent. However, this rise appears to have resulted from the increase in the price of oil which rose from approximately $96 per barrel to $140 per barrel over that period of time.

Measured in standardized futures contract equivalents these figures equate to an 11 percent decline in aggregate positions of commodity index participants during this 6 month period from approximately 408,000 contracts to 363,000 contracts. The numbers of futures equivalent positions held by index investors in other agriculture commodities appeared to remain relatively stable during this volatile 6 month period.

When looking at the types of entities investing in commodity indexes, not surprisingly, staff found a significant percentage of those index investments held by pension funds, endowments and other large institutions. The CFTC staff survey also revealed that nine percent of the commodity index investments were held by several sovereign wealth funds located in North America, Europe and Asia.

Staff also looked to determine whether the clients of swap dealers were putting on positions that would have exceeded exchange position limits or accountability levels when combined with the client's on-exchange activity.

Looking at our most recent snapshot of June 30th, of the 550 clients identified in the more than 30 markets analyzed, the survey showed 35 instances across 13 markets where 18 noncommercial traders appeared to have an aggregate on-exchange and over-the-counter position above a speculative limit or an exchange accountability level.

While these combined positions do not violate current regulations and the excess amounts were generally small, information regarding those who significantly exceeded limits or levels would be useful in the CFTC surveillance of the central futures markets.

In light of the preliminary data and findings, the Commission believes that certain constructive steps can and should be taken. It presents several recommendations including: a complete review of the trader classification categories, including the removal of swap dealers from the commercial category and the creation of a new swap dealer classification for reporting purposes; the development and publication of a new periodic supplemental report on OTC swap dealer activity modeled after this report; the creation of a new CFTC Office of Data Collection whose sole mission is to collect, verify, audit and publish all of the agency's Commitments of Traders information; the establishment of more detailed reporting standards for certain large traders on regulated futures exchanges to ensure a more precise picture of their trading activity; the development of an advanced notice of proposed rulemaking that would review eliminating the *bona fide* hedge exemption for swap dealers and replace it with a limited risk management exemption; and the request that the Commission be provided with adequate funding to meet its current mission, the expanded activities outlined today, and any other additional responsibilities.

While the report's findings are useful and instructive; the data collection analysis needs to continue if the agency is to get a clear picture on this vast marketplace. However, these preliminary recommendations represent enhanced transparency, increased reporting and information, and improved controls and practices in overseeing these markets while keeping our futures markets competitive, open and on U.S. soil.

In conclusion, the CFTC must remain diligent in fulfilling its critical public mission. I certainly want to thank the 40 CFTC staff who put over 4,000 staff hours into the completion of this report. I can attest firsthand, and some of them are with us here today, that the CFTC is working hard to protect the public and I commend their extraordinary efforts.

I thank you very much for the opportunity to appear today, and I welcome any questions the Committee may have.

[The prepared statement of Mr. Lukken follows:]

PREPARED STATEMENT OF HON. WALTER LUKKEN, ACTING CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Chairman Etheridge, Ranking Member Goodlatte, and other distinguished Members, thank you for inviting me to testify before this Committee about the Commodity Futures Trading Commission's (CFTC or Commission) review of recent trading activity in the futures markets.

One of the core missions of the CFTC is protecting the sanctity, effectiveness and efficiency of the central price discovery process on futures exchanges. If prices are not reflecting fundamental factors of supply and demand, the futures markets are not functioning properly and all Americans suffer. Recent record prices in energy and agricultural commodities have underscored this point. If there is a lack of confidence in the validity of the price of a commodity, commercial participants will be less likely to manage risk in the futures markets. Furthermore, those involved with commercial merchandising of a physical commodity, such as a utility or grain elevator, will be hesitant to forward contract with customers if there is doubt about the basis of a price discovered on the futures markets. This is why the CFTC's core mission of protecting the central price discovery process is so important.

With the growth of electronic trading, globalization and financial innovation, we have witnessed the development of satellite financial markets that complement and compete with the centralized and regulated futures markets in the United States. During the last year, the CFTC has systematically been reviewing these develop-

ments to determine whether these satellite markets are having an impact on the centralized price discovery process and to make regulatory adjustments as needed.

Last summer the CFTC began with an examination of Exempt Commercial Markets (ECMs)—those less-regulated electronic trading platforms that allow institutions to trade certain over-the-counter swap contracts. After holding a hearing on the matter, the CFTC provided a report and recommendations to this Committee that grants additional authorities to the agency when products on these exchanges begin to serve as significant price discovery contracts that may be linked to the regulated marketplace. I want to thank this Committee for including those recommendations as part of the recently-enacted farm bill, which we are in the midst of implementing.

Linkages between markets are not purely a domestic occurrence but also exist across international borders. In May and June, the CFTC announced certain modifications to its Foreign Board of Trade (FBOT) policy that imposes conditions on the process that allows FBOTs to directly access U.S. participants. The conditions include position and accountability limits on any contract whose price is linked to the price of a U.S. contract traded on an exchange. The CFTC also announced it is enhancing its ongoing information sharing by requiring daily large trader reports on these linked contracts. These improvements were necessary due to the possibility that these linked markets could influence prices on the centralized futures market in the United States.

For both ECMs and FBOTs, this combination of enhanced information data and additional market controls will help the CFTC in its surveillance of its regulated domestic exchanges when these satellite markets have the ability to impact the price discovery process.

Today's hearing is meant to review the role of swap dealers and index traders and whether their connection to the futures markets is having an impact on the price of commodities. There is public and Congressional concern about the amount of index money flowing into the commodity markets and whether this passive investment is impacting the price discovery process that consumers and producers rely on. In May, the CFTC announced that it would use its special call authority to gather more detailed data from swap dealers on the amount of index trading occurring in the OTC markets and to examine whether index traders are being properly classified for regulatory and reporting purposes.

The CFTC staff in this report has collected and compiled substantial information on index funds and other transactions that are being conducted through swap dealers. I committed to Congress that we would provide this report no later than September 15. Given this Committee's hearing and interest in the report, I am pleased to present the CFTC's staff report with Commission recommendations. Although this has proven to be a huge undertaking for our staff and the agency, it is a critical endeavor to ensure that our markets are functioning properly.

CFTC Report on Swap Dealer and Index Trader Activity

This staff report represents a survey of swap dealers and commodity index funds to better characterize their activity and understand their potential to influence the futures markets. This type of a compelled survey relating to off-exchange activity is unprecedented, but the growth and evolution in futures market participation and growing public concern regarding off-exchange activity supported the need for this extraordinary regulatory inquiry.

In June 2008, Commission staff initiated a special call to futures traders, which included 43 request letters issued to 32 entities and their sub-entities. These entities include swap dealers engaged in commodity index business, other large swap dealers, and commodity index funds. The special call required all entities to provide data relating to their total activity in the futures and OTC markets, and to categorize the activities of their customers for month-end dates beginning December 31, 2007 through June 30, 2008, and continuing thereafter.

The scope of the survey attempts to answer the following questions:

- How much total commodity index trading is occurring in both the OTC and on-exchange markets?
- How much commodity index trading is occurring by specific commodity in both the OTC and on-exchange markets?
- What are the major types of index investors?
- What types of clients utilize swap dealers to trade OTC commodity transactions?
- To what extent would the swap clients have exceeded position limits or accountability levels had their OTC swap positions been taken on-exchange?

The preliminary survey results represent the best data currently available to the staff and the results present the best available snapshot of swap dealers and commodity index traders for the relevant time period. However, as a result of the survey limitations, there may be a margin of error in the precision of the data, which will improve as the staff continues to work with the relevant firms and to further review and refine the data. As entities continue to provide monthly data to the Commission in response to their ongoing obligation to comply with the special call, Commission staff will continue to examine the data, refine the specific requests, and further develop the analysis.

Findings:

In analyzing the total OTC and on-exchange positions for index trading, the report focuses on three quarterly snapshots—December 31, 2007, March 31, 2008, and June 30, 2008 and has thus far revealed the following data:

- *Total Net Commodity Index Investments:* The estimated aggregate net amount of all commodity index trading (combined OTC and on-exchange activity) on June 30, 2008 was $200 billion, of which $161 billion was tied to commodities traded on U.S. markets regulated by the CFTC. Of the $161 billion combined total, a significant amount of the OTC portion of that total likely is never brought to the U.S. futures markets.
- *Net Notional Index Values* ***Versus*** *Total Notional Market Values:* For comparison purposes, the total notional value on June 30, 2008 of all futures and options open contracts for the 33 U.S. exchange-traded markets that are included in major commodity indexes was $945 billion—the $161 billion net notional index value was approximately 17 percent of this total.
  - The total notional value of futures and options open contracts on June 30, 2008 for NYMEX crude oil was $405 billion—the $51 billion net notional index value was approximately 13 percent of this total.
  - The total notional value of futures and options open contracts on June 30, 2008 for CBOT wheat was $19 billion—the $9 billion net notional index value was approximately 47 percent of this total.
  - The total notional value of futures and options open contracts on June 30, 2008 for CBOT corn was $74 billion—the $13 billion net notional index value was approximately 18 percent of this total.
  - The total notional value of futures and options open contracts on June 30, 2008 for ICE-Futures cotton was $13 billion—the $3 billion net notional index value was approximately 23 percent of this total.
- *Crude Oil Index Activity:* While oil prices rose during the period December 31, 2007 to June 30, 2008, the activity of commodity index traders during this period reflected a net decline of swap contracts as measured in standardized futures equivalents.
  - During this period, the net notional amount of commodity index investment related to NYMEX crude oil rose from about $39 billion to $51 billion—an increase of more than 30 percent. This rise in notional value, however, appears to have resulted entirely from the increase in the price of oil, which rose from approximately $96 per barrel to $140 per barrel—an increase of 46 percent.
  - Measured in standardized futures contract equivalents, the aggregate long positions of commodity index participants in NYMEX crude oil declined by approximately 45,000 contracts during this 6 month period—from approximately 408,000 contracts on December 31, 2007 to approximately 363,000 contracts on June 30, 2008. This amounts to approximately an 11 percent decline.
- *Types of Index Investors:* Of the total net notional value of funds invested in commodity indexes on June 30, 2008, approximately 24 percent was held by "Index Funds," 42 percent by "Institutional Investors," nine percent by "Sovereign Wealth Funds," and 25 percent by "Other" traders.
- *Clients Exceeding Position Limits or Accountability Levels:* On June 30, 2008, of the 550 clients identified in the more than 30 markets analyzed, the survey data shows 18 noncommercial traders in 13 markets who appeared to have an aggregate (all on-exchange futures positions plus all OTC equivalent futures combined) position that would have been above a speculative limit or an exchange accountability level if all the positions were on-exchange. These 18 noncommercial traders were responsible for 35 instances of either exceeding a speculative limit or an exchange accountability level through their aggregate on-exchange and OTC trading that day. Of these instances:

- 8 were above the NYMEX accountability levels in the natural gas market;
- 6 were above the NYMEX accountability levels in the crude oil market;
- 6 were above the speculative limit on the CBOT wheat market;
- 3 were above the speculative limit on the CBOT soybean market; and
- 12 were in the remaining nine markets.

These combined positions do not violate current law or regulations and the amounts by which each trader exceeded a limit or level were generally small. However, there are a few instances where a noncommercial client's combined on-exchange futures positions and OTC equivalent futures positions significantly exceeded a position limit or exchange accountability level.

In light of the preliminary data and findings set forth herein, the Commission believes that, at a minimum, certain constructive steps can and should be taken and presents the following preliminary recommendations, several of which may benefit from legislative codification. The Commission will consider whether further recommendations are necessary as this survey and analysis continues.

Preliminary Recommendations:

1. Remove Swap Dealer from Commercial Category and Create New Swap Dealer Classification for Reporting Purposes: In order to provide for increased transparency of the exchange traded futures and options markets, the Commission has instructed the staff to develop a proposal to enhance and improve the CFTC's weekly Commitments of Traders (COT) Report by including more delineated trader classification categories beyond commercial and noncommercial, which may include at a minimum the addition of a separate category identifying the trading of swap dealers.

2. Develop and Publish a New Periodic Supplemental Report on OTC Swap Dealer Activity: In order to provide for increased transparency of OTC swap and commodity index activity, the Commission has instructed the staff to develop a proposal to collect and publish a periodic supplemental report on swap dealer activity. This report will provide a periodic "look through" from swap dealers to their clients and identify the types and amounts of trading occurring through these intermediaries, including index trading.

3. Create a New CFTC Office of Data Collection with Enhanced Procedures and Staffing: In order to enhance the agency's data collection and dissemination responsibilities, the Commission has instructed its staff to develop a proposal to create a new office within the Division of Market Oversight, whose sole mission is to collect, verify, audit, and publish all the agency's COT information. The Commission has also instructed the staff to review its policies and procedures regarding data collection and to develop recommendations for improvements.

4. Develop "Long Form" Reporting for Certain Large Traders to More Accurately Assess Type of Trading Activity: The Commission has instructed staff to develop a supplemental information form for certain large traders on regulated futures exchanges that would collect additional information regarding the underlying transactions of these traders so there is a more precise understanding of the type and amount of trading occurring on these regulated markets.

5. Review Whether to Eliminate *Bona Fide* Hedge Exemptions for Swap Dealers and Create New Limited Risk Management Exemptions: The Commission has instructed staff to develop an advanced notice of proposed rulemaking that would review whether to eliminate the bona fide hedge exemption for swap dealers and replace it with a limited risk management exemption that is conditioned upon, among other things: (1) an obligation to report to the CFTC and applicable self regulatory organizations when certain noncommercial swap clients reach a certain position level; and/or (2) a certification that none of a swap dealer's noncommercial swap clients exceed specified position limits in related exchange-traded commodities.

6. Additional Staffing and Resources: The Commission believes that substantial additional resources will be required to successfully implement the above recommendations. The CFTC devoted more than 30 employees and 4000 staff hours to this survey, which the Commission is now recommending to produce on a periodic basis. Other new responsibilities will also require similar additional staff time and resources. Accordingly, the Commission respectfully recommends that Congress provide the Commission with funding adequate to

meet its current mission, the expanded activities outlined herein, and any other additional responsibilities that Congress asks it to discharge.

7. Encourage Clearing of OTC Transactions: The Commission believes that market integrity, transparency and availability of information related to OTC derivatives are improved when these transactions are subject to centralized clearing. Accordingly, the Commission will continue to promote policies that enhance and facilitate clearing of OTC derivatives whenever possible.

8. Review of Swap Dealer Commodity Research Independence: Many commodity swap dealers are large financial institutions engaged in a range of related financial activity, including commodity market research. Questions have been raised as to whether swap dealer futures trading activity is sufficiently independent of any related and published commodity market research. Accordingly, the Commission has instructed the staff to utilize existing authorities to conduct a review of the independence of swap dealers' futures trading activities from affiliated commodity research and report back to the Commission with any findings.

In sum, this special call data and analysis has given the CFTC a snapshot of the OTC market. While the report's findings are useful and instructive, the data collection and analysis need to continue if the agency is to get a clearer, moving picture of this vast marketplace. The Commission's recommendations include enhanced transparency, increased reporting and information, and an overall modernization of several rules, regulations and practices used to oversee the markets. These changes will improve controls while ensuring that our futures markets remain competitive, open, and on U.S. soil.

Conclusion

The CFTC must remain diligent in fulfilling its critical public mission, and I expect this fall will continue to be busy on that front. Next week, I will be attending a meeting of the Technical Committee of the International Organization of Securities Commissions (IOSCO), which is the international standard setter for securities and futures markets. During the formal meeting, I plan to discuss the recent volatility of the futures markets and whether the current international standards for derivatives markets are adequate or need further review in light of current market conditions. Separately, on the domestic front, the Interagency Task Force on Commodity Markets continues its work on a final report on commodity market conditions and will make public its findings as soon as possible.

It is also important to note that the legislative, regulatory, and policy developments outlined today occur in tandem with our robust enforcement program. That program continues to ferret out price manipulations or attempted manipulations of our nation's vital commodity markets.

I cannot close my testimony without directly addressing the agency's funding situation. As I have testified in recent months and weeks, the lack of appropriate and predictable funding over the course of many years has had a negative impact on our staffing situation, rendering it unsustainable for the long run. Nothing has brought this point to bear more than our work on the swaps report, to which the CFTC has devoted more than 30 employees and 4,000 staff hours.

The agency is operating under a $111 million budget and at its lowest staffing levels in its history. And yet, we have been asked to do more and more with less. As Congress considers any new authorities and initiatives in order to respond to changing market conditions, it is imperative that Congress provide the CFTC with adequate funding for its current duties and additional funding for any new ones. Due to funding shortfalls, the agency cannot take on any additional responsibilities without making very difficult sacrifices in other mission-critical areas.

The CFTC is working hard to protect the public and the market users from manipulation, fraud, and abusive practices in order to ensure that the futures markets are working properly. Thank you for the opportunity to appear before you today on behalf of the CFTC. I would be happy to answer any questions you may have.

Staff Report on
Commodity Swap Dealers & Index Traders with Commission Recommendations

COMMODITY FUTURES TRADING COMMISSION

SEPTEMBER

2008

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EXECUTIVE SUMMARY

The following is a CFTC staff report on the special call survey of swap dealers and index traders, with several preliminary Commission recommendations.

Major changes in the composition of futures market participants have developed over the last 20 years. Specifically, there has been an influx of new traders into the market – commodity index traders (including pension and endowment funds) that seek exposure to commodities through passive long-term investment in commodity indexes, and swap dealers that seek to hedge price risk resulting from their over-the-counter (OTC) activity. In addition to those changes, volume growth on futures markets has increased fivefold in the last decade, and in the last year, the price and volatility of oil and other commodities have reached unprecedented levels. In light of these developments, the Commodity Futures Trading Commission (CFTC or Commission) staff has undertaken a survey of swap dealers and commodity index funds to better characterize their activity and understand their potential to influence the futures markets. This type of a compelled survey relating to off-exchange activity is unprecedented, but the growth and evolution in futures market participation and growing public concern regarding off-exchange activity supported the need for this extraordinary regulatory inquiry.

The development of the OTC swap industry is related to the exchange-traded futures and options industry in that a swap agreement can function as a competitor or complement to futures and option contracts. Market participants often use swap agreements because they offer the ability to customize contracts to match particular hedging or price exposure needs. Conversely, futures markets typically involve standardized contracts that, while often traded in very liquid markets, may not precisely meet the needs of a particular hedger or speculator.

The swap dealer, which is often affiliated with a bank or other large financial institution, has emerged to serve as a bridge between the OTC swap market and the futures markets. Swap dealers act as swap counterparties both to commercial firms seeking to hedge price risks and to speculators seeking to gain price exposure. In essence, swap dealers function as aggregators or market makers, offering contracts with tailored terms to their clients before utilizing the more standardized futures markets to manage the resulting risk. The bilateral contracts that swap dealers create vary widely - from contracts tailored to customer needs, to relatively standardized contracts (some virtually identical to an exchange-traded futures contract). Because swap agreements can be highly customized and the liquidity for a particular swap contract can be low, swap dealers often rely on a variety of means, including other swaps, physical market positions, and futures contracts to offset the residual market risks in their swap book.

Since 1991, the Commission has granted hedge exemptions to swap dealers (in regulated futures markets that have Federal speculative position limits) to manage the price risk on their books that results from serving as a market maker to OTC clients. Separately, the Commission has classified the trading activity of swap dealers as commercial rather than noncommercial in its weekly public Commitments of Traders report (COT) because swap dealers use futures markets for the commercial purpose of hedging their price risk. As this survey shows, futures market trades by swap dealers are essentially an amalgam of hedging and speculation by their clients.

Thus, any particular trade that a swap dealer brings to the futures market may reflect information and decisions that originated with a hedger, a speculator, or some combination of both.

A commodity index trader, which includes pension and endowment funds seeking exposure to commodities, is a passive, transparent investor in commodity markets. The investment objective of a commodity index trader is to track an index of commodities over time by acquiring long positions via OTC swap contracts, index funds, or exchange-traded futures. The larger commodity index traders typically gain commodity exposure through swap dealers.

In June 2008, Commission staff initiated a special call to futures traders, which included 43 requests issued to 32 entities and sub-entities. These entities include swap dealers engaged in commodity index business, other large swap dealers, and commodity index funds. The special call required all entities to provide data relating to their total activity in the futures and OTC markets, and to categorize the activities of their customers, for month-end dates beginning December 31, 2007 through June 30, 2008, and continuing thereafter. All entities complied.

The scope of the survey attempts to answer the following questions:

- How much total commodity index trading is occurring in both the OTC and on-exchange markets?
- How much commodity index trading is occurring by specific commodity in both the OTC and on-exchange markets?
- What are the major types of index investors?
- What types of clients utilize swap dealers to trade OTC commodity transactions?
- To what extent would swap clients have exceeded position limits or accountability levels had their OTC swap positions been taken on-exchange?

This preliminary survey is not able to accurately answer and quantify the amount of speculative trading occurring in the futures markets. The current data received by the CFTC classifies positions by entity (commercial versus noncommercial) and not by trading activity (speculation versus hedging). These trader classifications have grown less precise over time, as both groups may be engaging in hedging and speculative activity. Importantly, as a result of this survey, the Commission recommends improvements to the classification process and reporting requirements for large traders that will help the agency better quantify the nature and accuracy of trading activity being conducted on exchanges.

This preliminary survey was an unprecedented effort to quantify key components of the OTC swap and commodity index markets. It called for collection, organization, and analysis of the OTC trading of hundreds of counter-parties, millions of transactions, and billions of dollars of trading occurring over a 6-month period. The expedited timing of the survey presented a challenge to staff to process and analyze the large volume of OTC market information. Nonetheless, the preliminary survey results represent the best data currently available to the staff and the results present the best available snapshot of swap dealers and commodity index traders for the relevant time period. However, as a result of the survey limitations, there may be a margin of error in the precision of the data, which will improve as the staff continues to work with the relevant firms and to further review and refine the data.

Findings:

In analyzing the total OTC and on-exchange positions for index trading, this report focuses on three quarterly snapshots – December 31, 2007, March 31, 2008, and June 30, 2008 and has thus far revealed the following preliminary data:

TOTAL OTC AND ON-EXCHANGE COMMODITY INDEX INVESTMENT ACTIVITY

	December 31, 2007	March 31, 2008	June 30, 2008
Index Investments in Net Notional Value	$146 billion	$168 billion	$200 billion
Index Investments in Net Notional Value – U.S. Exchanges Only	$118 billion	$133 billion	$161 billion
NYMEX Crude Oil—Index Notional Value	$39 billion	$41 billion	$51 billion
Crude Oil Index Values Measured in Futures Equivalents	408,000	398,000	363,000
NYMEX Crude Oil Price	$96 bbl.	$102 bbl.	$140 bbl.
CBOT Wheat – Index Notional Value	$8 billion	$9 billion	$9 billion
CBOT Wheat Index Values Measured in Futures Equivalents	185,000	188,000	194,000
CBOT Wheat Price	$8.85 bu.	$9.29 bu.	8.44 bu.
CBOT Corn—Index Notional value	$8 billion	$10 billion	$13 billion
CBOT Corn Index Values Measured in Futures Equivalents	326,000	362,000	350,000
CBOT Corn Price	$4.56 bu.	$5.67 bu.	$7.25 bu.
ICE-Futures Cotton—Notional Value	$3 billion	$3 billion	$3 billion
ICE-Futures Cotton Index Values Measured in Futures Equivalents	72,000	73,000	73,000
ICE-Futures Cotton Price	$.68 lb.	$.69 lb.	$.71 lb.

- Total Net Commodity Index Investments: The estimated aggregate net amount of all commodity index trading (combined OTC and on-exchange activity) on June 30, 2008 was $200 billion, of which $161 billion was tied to commodities traded on U.S. markets regulated by the CFTC. Of the $161 billion combined total, a significant amount of the OTC portion of that total likely is never brought to the U.S. futures markets due to internal netting by swap dealers.

- Net Notional Index Values vs. Total Notional Market Values: For comparison purposes, the total notional value on June 30, 2008 of all futures and options open contracts for the 33 U.S. exchange-traded markets that are included in major commodity indexes was $945 billion – the $161 billion net notional index value was approximately 17 percent of this total.

    - The total notional value of futures and options open contracts on June 30, 2008 for NYMEX crude oil was $405 billion – the $51 billion net notional index value was approximately 13 percent of this total.
    - The total notional value of futures and options open contracts on June 30, 2008 for CBOT wheat was $19 billion – the $9 billion net notional index value was approximately 47 percent of this total.
    - The total notional value of futures and options open contracts on June 30, 2008 for CBOT corn was $74 billion - the $13 billion net notional index value was approximately 18 percent of this total.
    - The total notional value of futures and options open contracts on June 30, 2008 for ICE-Futures cotton was $13 billion – the $3 billion net notional index value was approximately 23 percent of this total.

- Crude Oil Index Activity: While oil prices rose during the period December 31, 2007 to June 30, 2008, the activity of commodity index traders during this period reflected a net decline of swap contracts as measured in standardized futures equivalents.[1]

    - During this period, the net notional amount of commodity index investment related to NYMEX crude oil rose from about $39 billion to $51 billion—an increase of more than 30 percent.[2] This rise in notional value appears to have resulted from the increase in the price of oil, which rose from approximately $96 per barrel to $140 per barrel—an increase of 46 percent.

    - Measured in standardized futures contract equivalents, the aggregate long positions of commodity index participants in NYMEX crude oil declined by approximately 45,000 contracts during this 6 month period - from approximately 408,000 contracts on December 31, 2007 to approximately 363,000 contracts on June 30, 2008. This amounts to approximately an 11 percent decline.

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[1] "Futures contract equivalents" are described in Section 4A, n.29.

[2] For the West Texas Intermediate (WTI) crude oil contract traded on the New York Mercantile Exchange (NYMEX), as of June 30, 2008, the Commission's special call covered 90 percent or more of the actual total long and the total short futures and options positions held by all of the swap dealers and represented essentially all of the index trading done through swap dealers.

- Types of Index Investors: Of the total net notional value of funds invested in commodity indexes on June 30, 2008, approximately 24 percent was held by "Index Funds," 42 percent by "Institutional Investors," 9 percent by "Sovereign Wealth Funds," and 25 percent by "Other" traders.[3]

- Clients Exceeding Position Limits or Accountability Levels[4]: On June 30, 2008, of the 550 clients identified in the more than 30 markets analyzed, the survey data shows 18 noncommercial traders in 13 markets who appeared to have an aggregate position (all on-exchange futures positions plus all OTC equivalent futures combined) that would have been above a speculative limit or an exchange accountability level if all the positions were on-exchange. These 18 noncommercial traders were responsible for 35 instances that would have exceeded either a speculative limit or an exchange accountability level through their aggregate on-exchange and OTC trading that day. Of these instances:

    - 8 were above the NYMEX accountability levels in the natural gas market;
    - 6 were above the NYMEX accountability levels in the crude oil market;
    - 6 were above the speculative limit on the CBOT wheat market;
    - 3 were above the speculative limit on the CBOT soybean market; and
    - 12 were in the remaining 9 markets.

These combined positions do not violate current law or regulations and the amounts by which each trader exceeded a limit or level were generally small. However, there were a few instances where a noncommercial client's combined on-exchange futures positions and OTC equivalent futures positions significantly exceeded a position limit or exchange accountability level.

In light of the preliminary data and staff findings set forth herein, the Commission believes that certain constructive steps can and should be taken, and has approved the following recommendations,[5] several of which may benefit from legislative codification. The Commission will consider whether further recommendations are necessary as this survey and analysis continues.

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[3] These categories are discussed in greater detail in Section 4A.

[4] Position limits are hard limits that a trader's on-exchange position may not exceed without the trader potentially violating the Commodity Exchange Act (CEA or Act). By contrast, accountability levels are position levels that if exceeded, may trigger additional exchange scrutiny of the positions and requests from the exchange for information concerning the positions. Exceeding accountability levels is not a violation of the CEA; accountability levels are simply a regulatory tool of the exchange used to identify and monitor positions that reach a certain size and do not preclude maintaining or adding to the position. Position accountability rules apply to contracts that are less likely to be susceptible to the threat of manipulation. Pursuant to Commission regulation 150.5(e), contracts that have an established trading history (i.e., listed for at least 12 months), experience significant open interest and trading volume, have liquid cash and futures markets, and are readily arbitraged, may be subject to a position accountability rule rather than a numerical position limit.

[5] *But see* Dissent of Commissioner Bart Chilton, Appendix G.

Preliminary Recommendations:

1. **Remove Swap Dealer from Commercial Category and Create New Swap Dealer Classification for Reporting Purposes:** In order to provide for increased transparency of the exchange traded futures and options markets, the Commission has instructed the staff to develop a proposal to enhance and improve the CFTC's weekly Commitments of Traders Report by including more delineated trader classification categories beyond commercial and noncommercial, which may include at a minimum the addition of a separate category identifying the trading of swap dealers.

2. **Develop and Publish a New Periodic Supplemental Report on OTC Swap Dealer Activity:** In order to provide for increased transparency of OTC swap and commodity index activity, the Commission has instructed the staff to develop a proposal to collect and publish a periodic supplemental report on swap dealer activity. This report will provide a periodic "look through" from swap dealers to their clients and identify the types and amounts of trading occurring through these intermediaries, including index trading.

3. **Create a New CFTC Office of Data Collection with Enhanced Procedures and Staffing:** In order to enhance the agency's data collection and dissemination responsibilities, the Commission has instructed its staff to develop a proposal to create a new office within the Division of Market Oversight, whose sole mission is to collect, verify, audit, and publish all the agency's COT information. The Commission has also instructed the staff to review its policies and procedures regarding data collection and to develop recommendations for improvements.

4. **Develop "Long Form" Reporting for Certain Large Traders to More Accurately Assess Type of Trading Activity:** The Commission has instructed staff to develop a supplemental information form for certain large traders on regulated futures exchanges that would collect additional information regarding the underlying transactions of these traders so there is a more precise understanding of the type and amount of trading occurring on these regulated markets.

5. **Review Whether to Eliminate *Bona Fide* Hedge Exemptions for Swap Dealers and Create New Limited Risk Management Exemptions:** The Commission has instructed staff to develop an advanced notice of proposed rulemaking that would review whether to eliminate the *bona fide* hedge exemption for swap dealers and replace it with a limited risk management exemption that is conditioned upon, among other things: 1) an obligation to report to the CFTC and applicable self regulatory organizations when certain noncommercial swap clients reach a certain position level and/or 2) a certification that none of a swap dealer's noncommercial swap clients exceed specified position limits in related exchange-traded commodities.

6. **Additional Staffing and Resources:** The Commission believes that substantial additional resources will be required to successfully implement the above recommendations. The CFTC devoted more than 30 employees and 4000 staff hours to this survey, which the Commission is now recommending to produce on a periodic basis. Other new

responsibilities will also require similar additional staff time and resources. Accordingly, the Commission respectfully recommends that Congress provide the Commission with funding adequate to meet its current mission, the expanded activities outlined herein, and any other additional responsibilities that Congress asks it to discharge.

7. **Encourage Clearing of OTC Transactions:** The Commission believes that market integrity, transparency, and availability of information related to OTC derivatives are improved when these transactions are subject to centralized clearing. Accordingly, the Commission will continue to promote policies that enhance and facilitate clearing of OTC derivatives whenever possible.

8. **Review of Swap Dealer Commodity Research Independence:** Many commodity swap dealers are large financial institutions engaged in a range of related financial activity, including commodity market research. Questions have been raised as to whether swap dealer futures trading activity is sufficiently independent of any related and published commodity market research. Accordingly, the Commission has instructed the staff to utilize existing authorities to conduct a review of the independence of swap dealers' futures trading activities from affiliated commodity research and report back to the Commission with any findings.

1. Introduction

U.S. futures[6] markets have experienced tremendous growth during the past decade. In 1998, the total U.S. exchange-traded futures and futures option trading volume was approximately 630 million contracts. The annual trading volume figure has grown over five fold to 3.2 billion contracts traded in 2007. The pace of growth continues to accelerate in 2008 with the total trading volume exceeding last year's trading volume level by 17.3 percent for the period of January to July 2008.[7] The growth in exchange-traded futures trading has not been confined to any single commodity or futures exchange. In this regard, an annual comparison of total exchange-traded futures and futures options volume in 2007 versus 2006 showed that year over year, both financial futures and energy futures trading volume grew by over 27 percent, agricultural futures grew by 23 percent, and metal futures grew by 38 percent. The same comparison by futures exchanges shows that trading volume on each of the three largest U.S. futures exchanges grew by over 26 percent.[8]

The growth in trading activity on Commission-regulated futures exchanges, which are called Designated Contract Markets (DCMs), may also be measured by the number of large trader participants in the market. In monitoring the activities of futures markets, the Commission receives daily information on large traders' positions. Over the past ten years, the total number of large (reportable) traders that the Commission staff must process, track and analyze has grown by more than 26 percent. For specific individual commodity futures markets, the number of reportable traders in CBOT Corn, CBOT Wheat, and NYMEX WTI Crude Oil has increased by 43 percent, 116 percent, and 74 percent, respectively.

In addition to this unprecedented growth in volume and participation over the past decade, the futures industry also has witnessed new types of participants and trading strategies. Prior to the mid 1990s, the participants in the futures markets could be easily categorized into two broad major categories - commercial and noncommercial traders.[9] Commercial traders were entities that had some physical dealing or commercial activity with the underlying commodity and therefore faced some price risks in the cash market that were offset or hedged in the futures market. Noncommercial traders, often referred to as speculators, were the traders who usually took the opposite position to commercial traders, thereby providing liquidity to the market without necessarily having physical risk exposure that needed to be offset.

Today this classification by trading entity is less precise in describing the type of trading activity conducted by these entities than it was 25 years ago when the CFTC first began to use

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[6] For purposes of this report, the term "futures" refers to exchange-traded futures contracts.

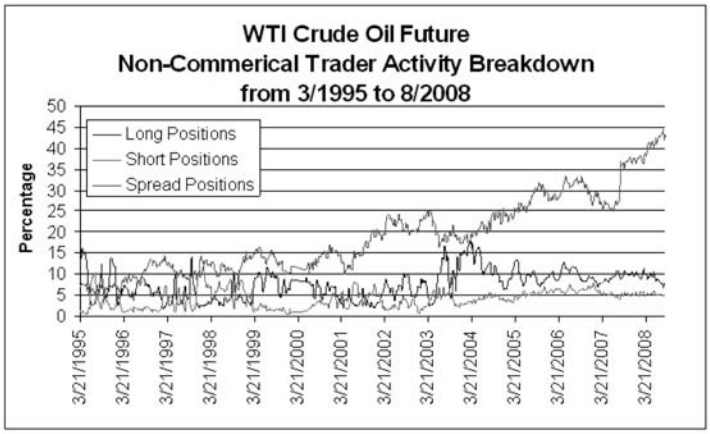
[7] Source: Futures Industry Association.

[8] These exchanges are the Chicago Mercantile Exchange (CME), the Chicago Board of Trade (CBOT), and the NYMEX (which includes the Comex Division) and collectively they represent about 98 percent of all U.S. futures and futures option trading.

[9] Although the CFTC for market surveillance purposes receives much greater detail on all large traders, it limits its classification of traders in its weekly Commitments of Traders report to commercial or noncommercial.

these classification categories. For example, some commercial traders may be speculating at times based on market information they obtain in the course of their commercial dealings. There are also swap dealers today that deal in the merchandising of the physical commodities.

The type of trading conducted by noncommercial traders has also changed significantly over time. For example, in the NYMEX crude oil market, a vast majority of noncommercial traders do not take direct long or short positions in the market where they would benefit directly from prices rising or falling. Rather, most noncommercial traders place spread positions, which amounts to simultaneously buying and selling in different months to trade on pricing relationships over certain time horizons. Spread trading for NYMEX Crude Oil with equal and offsetting long and short positions has grown from roughly 10 percent of the market to over 40 percent of the market today. See graph below.



Recently, we have also witnessed the growth in participation of commodity swap dealers and commodity index traders in futures markets. Historically, commodity returns tend to be negatively correlated to stock market and bond market returns. As such, it has become attractive for some investors to include commodities exposure as a way to balance an overall portfolio. Moreover, because commodity returns are often positively correlated with inflation, it is possible for investors to invest in commodities as a means to hedge against rising inflation. Due to these factors, more investors have sought commodity exposure as a way to achieve portfolio diversification, and the commodity swap dealer business has flourished.

These paradigm shifts in the structure of futures markets have occurred during a period where many commodities have reached record high prices. For example, CBOT's wheat futures contract reached a record high of $13.00 per bushel on February 27, 2008. Similarly, corn

reached a record price of $7.625 on June 27, 2008. There were other notable record high prices for other agricultural markets including rice, soybeans, and oats.[10]

In addition to record agricultural prices, energy prices also reached record highs in July 2008. The nearby futures price for the NYMEX WTI crude oil contract traded at a record price of $147.27 per barrel on July 11, 2008. On the same day, refined oil products set new records, with gasoline futures prices hitting $3.63 per gallon and heating oil futures prices hitting $4.16 per gallon.

In light of all of these market developments, on May 29, 2008 and June 3, 2008, the Commission announced several market initiatives related to the energy and agricultural markets. These initiatives included the Commission using its special call authority to require certain traders and swap dealers to provide regular reports of their index trading activity so the Commission could better identify the amount and impact of index trading on the energy and agricultural markets. This report outlines the results thus far and the staff analysis of the data received to date.

2. Development of Swap Markets and Swap Dealers

From the inception of U.S. futures trading in the mid 1800s until recently, regulated futures exchanges offered the primary means by which commercial entities could manage their physical market price risks. During the 1980s, however, financial institutions began to develop non-exchange-traded derivatives contracts that offered similar risk management benefits. In 1981, the World Bank and IBM entered into what has become known as a currency swap. The swap essentially involved a loan of Swiss francs by IBM to the World Bank and the loan of U.S. dollars by the World Bank to IBM. The motivation for the transaction was the ability of each party to borrow the funds they were loaning more cheaply than the counterparty, thus reducing overall funding costs for both parties. This structure of swapping cash flows ultimately served as the template for swaps on any number of financial assets and commodities.

Financial institutions then looked at the fixed income markets and found that swaps that provided for the exchange of a fixed rate for a floating rate (e.g., the interest rate on Treasury Bills "swapped" for the London Interbank Offer Rate (LIBOR)) served as an effective hedging vehicle in much the same way that financial futures contracts do. For example, a typical futures contract has many of the same characteristics as a swap in that it is essentially a contract where the buyer of the contract agrees at the outset to pay a fixed price for a commodity in return for future delivery of the commodity which will have an uncertain or floating value at the time of expiration of the contract.[11]

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[10] The nearby contract futures price for rice reached a record price of $24.46 on April 23, 2008; soybeans reached a record price of $16.60 on July 3, 2008; and oats reached a record price of $4.55 on July 3, 2008.

[11] Title III of the Commodity Futures Modernization Act of 2000 (CFMA) addressed legal certainty for swap agreements. *See* Commodity Futures Modernization Act of 2000, Pub. L. 106-554, Appendix E, Sections 301 - 304, 114 Stat. 2763A, 449 - 457 (2000). CFMA Section 301 amended the Gramm-Leach-Bliley Act to define "swap agreement," and excluded certain transactions from the definition. CFMA

The party offering the swap, typically called a swap dealer, takes on any price risks associated with the swap and thus must manage the risk of the commodity exposure. In the early development of swap markets, investment banks often served in a brokering capacity to bring together parties with opposite hedging needs. The currency swap between the World Bank and IBM, for example, was brokered by Salomon Brothers. While brokering swaps eliminates market price and credit risk to the broker, the process of matching and negotiating swaps between counterparties with opposite hedging needs could be difficult. As a result, swap brokers (who took on no market risk) evolved into swap dealers (who took the contract onto their books).

As noted, when a swap dealer takes a swap onto its books, it takes on any price risks associated with the swap and thus must manage the risk of the commodity exposure. In addition, the counterparty bears a credit risk that the swap dealer may not honor its commitment. This risk can be significant in the case of a swap dealer because it is potentially entering into numerous transactions involving many counterparties, each of which exposes the swap dealer to additional credit risks. As a result of these risks, there has been a natural tendency for financial intermediaries (e.g., commercial banks, investment banks, insurance companies) to become swap dealers. These firms typically have the capitalization to support their creditworthiness as well as the expertise to manage the market price risks that they take on. In addition, for particular commodity classes, such as agriculture and energy, large commercial companies that have the expertise to manage market price risks have set up affiliates to specialize as swap dealers for those commodities.

The utility of swap agreements as a hedging vehicle has led to significant growth in both the size and complexity of the swap market. During the early period in the development of the swap market, the majority of swap agreements involved financial assets. In fact, even today the vast majority of swaps outstanding involve either interest rates or currencies. The Bank for International Settlements (BIS) estimated that at the end of 2007, a total of $156 trillion of notional value in OTC financial derivatives was outstanding, compared to approximately $9 trillion in physical commodity-related contracts. Thus, the financial-related portion of the OTC derivative market was, and is, significantly larger than the physical commodity-related portion.

The OTC swap market has grown significantly because, for many financial entities, the OTC derivatives products offered by swap dealers have distinct advantages relative to futures contracts. While futures markets offer a high degree of liquidity (i.e., the ability to quickly execute trades due to the high number of participants willing to buy and sell contracts), futures contracts are more standardized, meaning that they may not meet the exact needs of a hedger. Swaps, on the other hand, offer additional flexibility since the counterparties can tailor the terms of the contract to meet specific hedging needs.

As an example of the flexibility that swaps can offer, consider the case of an airline wanting to hedge future jet fuel purchases. Currently there is no jet fuel futures contract available to the airlines to directly hedge their price exposure. Contracts for crude oil (from which jet fuel is made) and heating oil (which is a fuel having similar chemical characteristics to jet fuel) do exist. But while these contracts can be used to hedge jet fuel (in what is referred to as

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Section 304, in turn, provided that nothing in the CFMA should be construed as finding or implying that a swap agreement is a security or a commodity under the federal securities laws or the CEA.

a "cross hedge"), the dissimilarities between jet fuel and crude oil or heating oil mean that the airline will inevitably take on what is known as "basis risk." That is, the price of jet fuel and the prices of these futures contracts will not tend to move perfectly together, diminishing the utility of the hedge.[12]

In contrast, swap dealers can offer the airline the alternative of entering into a contract that directly references the cash price for jet fuel at the specific time and location where the product is needed. By creating a customized OTC derivative product that specifically addresses the price risks faced by the airline, by taking on the administrative costs associated with managing that contract over time, and by assuming the price risks attendant to that contract, the swap dealer facilitates the airline's risk management.[13]

Swap agreements have also become a popular vehicle for noncommercial participants, such as hedge funds, pension funds, large speculators, commodity index traders, and others with large pools of cash, to gain exposure to commodity prices. Recently, portfolio managers have sought to invest in commodities because of the lack of correlation, or even negative correlation, that commodities tend to have with traditional investments in stocks and bonds. In addition, swaps, because of the ability to tailor transactions, can represent a more efficient means by which these participants can enter the market. Hence, many of the benefits that swap agreements offer commercial hedgers also attract noncommercial interests to the swap market.

Since swap dealers are willing to enter into swap contracts on either side of a market, at times they will enter into swaps that create offsetting exposures, reducing the swap dealer's overall market price risk associated with the firm's individual positions opposite its counterparties. Since it is unlikely, however, that a swap dealer could completely offset the market price risks associated with its swap business at all times, dealers often enter the futures markets to offset the residual market price risk. As a result of the growth of the swap market and the dealers who support the market, there has been an associated growth in the open interest of the futures markets related to the commodities for which swaps are offered, as these swap dealers attempt to lay off the residual risk of their swap book.

A more recent phenomenon in the derivatives market has been the development of commodity index funds and exchange-traded funds for commodities (ETFs) and exchange-traded

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[12] Although basis risk also would occur if a jet fuel contract did exist, it will be greater in the case where the underlying commodities do not match precisely.

[13] When a commercial entity uses a swap to offset its risk, the swap dealer assumes the price risk of the commodity. For example, if the swap dealer enters into a jet fuel swap with an airline, the airline agrees to periodically pay a fixed amount on the swap while the swap dealer pays a floating amount based on a cash market price. At each point in time when the payments are due, a netting of the obligations takes place and the party responsible for the larger payment pays the difference to the other party. Thus, if prices rise, the floating payment will be larger than the fixed price and the swap dealer pays the net amount to the airline. Conversely, if prices fall, the airline will be required to make a payment to the swap dealer. Recall, however, that when the airline makes a payment on the swap to the swap dealer, it means that at the same time, it is paying a lower price to acquire jet fuel in the cash market The swap dealer, however, has no natural offsetting transaction to counterbalance the risk. That is why swap dealers will, in turn, hedge this price risk in the regulated futures markets.

notes (ETNs), which are mainly transacted through swap dealers. Both products are designed to produce a return that mimics a passive investment in a commodity or group of commodities. ETFs and ETNs are traded on securities exchanges and are backed by physical commodities or long futures positions held in a trust. Commodity index funds are funds that enter into swap contracts that track published commodity indexes such as the S&P Goldman Sachs Commodity Index or the Dow Jones AIG Commodity Index. The vast majority of commodity index trading by principals is conducted off-exchange using swap contracts.

3. Swaps Exemption from Federal Speculative Position Limits

Beginning in the mid-1980s, derivatives trading and risk management practices began to evolve considerably. Under the Commission's definition at that time, "*bona fide* hedging" transactions in futures "normally represent[ed] a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel," and were "economically appropriate to the reduction of risks in the conduct of a commercial enterprise."[14] This aspect of the hedging definition proved to be ill-fitted to the economic realities of financial futures because portfolio managers utilize financial products to add incremental income to managed assets, to manage risk, or to rebalance a portfolio. These financial futures positions typically are taken as an alternative to cash market transactions (in view of their lower transaction costs, speed, and minimal price impact), rather than as a temporary substitute for positions that will later be taken in the underlying cash market.[15]

In 1986, Congress directed the Commission to keep the hedging definition consistent with evolving industry needs and practices. In response to concerns regarding artificial restraints on investment decisions imposed by position limits, the House Committee on Agriculture, in its Report accompanying the Commission's 1986 reauthorization legislation, instructed the Commission to re-examine its approach to speculative position limits and its definition of hedging.[16] Specifically, as to the hedging definition, the House Report "strongly urge[d] the Commission to undertake a review of its hedging definition . . . and to consider giving certain concepts, uses, and strategies 'non-speculative' treatment . . . whether under the hedging definition or, if appropriate, as a separate category similar to the treatment given certain spread, straddle or arbitrage positions …."[17]

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[14] 17 CFR 1.3(z)(1).

[15] Indeed, in view of his/her fiduciary duties, a portfolio manager may be constrained from closing out an "anticipatory hedge" position in stock index futures and investing in the underlying stocks if the market has moved in an unfavorable direction since the futures contract was entered into.

[16] H.R. Rep. No. 99-624, at 44-46 (1986).

[17] *Id.* at 46. The House Report singled out four categories of trading strategies that the Commission should recognize as "non-speculative:" (1) the concept of risk management by portfolio managers, as an alternative to the concept of "risk reduction;" (2) futures positions taken as alternatives to, rather than temporary substitutes for, cash market positions; (3) other trading strategies involving the use of financial futures including, but not limited to, asset allocation (altering portfolio exposure in certain areas such as equity and debt), portfolio immunization (curing mismatches between the duration and sensitivity of a pension fund's assets and liabilities to ensure that portfolio assets will be sufficient to fund payment of its

The Senate Committee on Agriculture, Nutrition, and Forestry, in its Report on the 1986 reauthorization legislation, "urge[d] the Commission to undertake a review of its hedging definition for the purpose of ensuring that the definition is, in fact, consistent with the legitimate needs and practices of the industry."[18] The Senate Committee specified that, as part of this review, the Commission should consider "whether the concept of prudent risk management [should] be incorporated in the general definition of hedging as an alternative to the risk reduction standard."[19]

In view of the direction from its authorizing committees to review its hedging definition to ensure that the definition was consistent with the current needs and practices of the industry, the Commission tasked its Financial Products Advisory Committee (FPAC) to deliberate on the issue and provide the Commission with recommendations. In 1987, the FPAC completed its review and unanimously voted to provide the Commission with a detailed report recommending an updated approach to evaluating *bona fide* hedging activities. The Commission staff then issued interpretive statements directing that "risk-management" be included as a type of speculative position limit exemption.[20]

In 1991, the Commission received a request from a large commodity merchandising firm that engaged in commodity related swaps as a part of its commercial line of business. The firm, through an affiliate, wished to enter into an OTC swap transaction with a large pension fund involving an index based on the returns afforded by investments in exchange-traded futures contracts on certain non-financial commodities. The commodities making up the index included wheat, corn, and soybeans, all of which were and remain subject to Federal speculative position limits. As a result of the swap, the swap dealer would, in effect, be exposed to short side commodity price risk. In other words, it would be required to make payments to the pension fund counterparty if the value of the index was higher at the end of the swap payment period than at the beginning. In order to hedge itself against this possible risk from the OTC swap, the swap dealer planned to establish a portfolio of long exchange-traded futures positions in the commodities making up the index, in such amounts as would replicate its exposure under the swap transaction.[21]

The Commission reviewed the request in light of the prior review, study, and amendment of the hedging definition and determined that the swap dealer's futures positions fulfilled the

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liabilities) and duration (altering the average maturity of a portfolio's assets); and (4) options transactions, in particular the writing of covered puts and calls. *Id.*

[18] S. Rep. 99-291, at 22 (1986).

[19] *Id.*

[20] *Risk Management Exemptions from Speculative Position Limits Approved under Commission Regulation 1.61*, 52 FR 34633 (September 14, 1987); *Clarification of Certain Aspects of the Hedging Definition,* 52 FR 27195 (July 20, 1987).

[21] By design, the index did not include contract months that had entered the delivery period and the swap dealer, in replicating the index, stated that it would not maintain futures positions based on index-related swap activity into the spot month (when physical commodity markets are most vulnerable to manipulation and attendant unreasonable price fluctuations).

requirements of regulation 1.47 to be classified as *bona fide* hedging, including the requirement of regulation 1.47(b)(2) that the swap dealer demonstrate that the positions were "economically appropriate to the reduction of risk exposure attendant to the conduct and management of a commercial enterprise."[22] Thereafter, the Commission granted the swap dealer a hedge exemption from the Federal speculative position limits in the relevant commodities. The swap transaction allowed the pension fund to add commodities exposure to its portfolio indirectly, through the OTC trade with the swap dealer – something it could have done directly, but only in a limited fashion.[23]

Similar hedge exemptions were subsequently granted in other cases where the futures positions clearly offset risks related to swaps or similar OTC positions involving both individual commodities and commodity indexes.[24] These non-traditional hedges were all subject to specific limitations to protect the marketplace from potential ill effects. These limitations included that: (1) the futures positions must offset specific market price risk; (2) the dollar value of the futures positions would be no greater than the dollar value of the underlying risk; and (3) the futures positions would not be carried into the spot (delivery) month. DCMs, in administering exchange speculative position limits pursuant to Commission regulation 150.5, may impose similar constraints when issuing hedge exemptions with respect to contracts subject to exchange limits. It is of note that the Commission grants hedge exemptions for the limited group of commodities subject to Federal speculative limits. This group does not include crude oil. Hedge exemptions for commodities not subject to Federal speculative limits are granted by the DCMs.

4. The Commission's Special Call to Swap Dealers

In May and June 2008, as part of its initiatives relating to the energy and agricultural markets, the Commission announced that it would gather more information regarding the off-exchange commodity trading activity of swap dealers and revisit whether swap dealers' futures

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[22] 17 CFR 1.47(b)(2).

[23] The pension fund would have been limited in its ability to take on this commodities exposure directly, by putting on the long futures position itself, because the pension fund – having no offsetting price risk incidental to commercial cash or spot operations – would not have qualified for a hedge exemption with respect to the position.

[24] More recently, Commission staff has issued two no-action letters involving another type of index-based trading. CFTC Letter 06-09 (April 19, 2006); CFTC Letter 06-19 (September 6, 2006). Both cases involved trading that offered investors the opportunity to participate in a broadly diversified commodity index-based fund or program ("index fund"). The futures positions of these index funds differ from the futures positions taken by the swap dealers described above. There, the swap dealer positions were taken to offset OTC swap exposure that was directly linked to the price of an index. By contrast, in the index fund positions described in the no-action letters, the price exposure results from a promise or obligation to track an index, rather than from holding an OTC swap position whose value is directly linked to the price of the index. Because the index fund positions represented a legitimate and potentially useful investment strategy, Commission staff granted the index funds no-action relief, subject to certain conditions intended to protect the futures markets from potential ill effects. These conditions included that: (1) the positions must be passively managed; (2) they must be unleveraged (so that financial conditions should not cause rapid liquidation of positions); and (3) the positions may not be carried into the delivery month (when physical delivery markets are most vulnerable to manipulation or congestion).

trading is being properly classified.[25] Thereafter, pursuant to its authority under regulation 18.05, the Commission issued a special call to swap dealers and index traders to gather pertinent information regarding these entities.[26] Prior to this special call, Commission staff had used the special call authority in a targeted fashion to obtain OTC market information for surveillance purposes from one or a few traders at a time in a single market when specific concerns about potential manipulation of a futures market had arisen. This authority had not been used previously to conduct expansive reviews of the activities of a broad segment of the OTC markets, as it is now being used. To accomplish such an unprecedented review of the OTC markets, approximately 35 Commission staff members spent a total of nearly 4000 hours on this special call over a 14-week period.

A. Scope of the Special Call

The special call involved staff issuing 43 written requests to 32 entities and their sub-entities compelling these futures traders to produce data relating to their OTC market activities.[27] Of the 43 requests, 16 were directed to swap dealers known to have significant commodity index swap business; 13 were directed to traders identified as swap dealers (but not known to engage in significant commodity index swap business) and who, at the time of the call, held futures positions that were large relative to Commission or exchange-set speculative position limits or accountability levels; and 14 were directed to commodity index funds (including asset managers and sponsors of ETFs and ETNs whose returns are based upon a commodity index).

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[25] *See* Commission press releases: http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5503-08.html and http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5504-08.html.

[26] Commission Regulation 18.05 provides that traders with reportable positions in any futures contract must, upon request, furnish to the Commission any pertinent information concerning the traders' positions, transactions, or activities involving the cash market as well as other derivatives markets, including their OTC business. Specifically, regulation 18.05, entitled "Maintenance of books and records," requires that every trader who holds or controls a reportable futures or option position shall keep books and records showing all details concerning all positions and transactions in the commodity: (1) On all reporting markets; (2) Over the counter and/or pursuant to Sections 2(d), 2(g) or 2(h)(1)–(2) of the CEA or Part 35 of the CFTC's regulations; (3) On exempt commercial markets operating pursuant to Sections 2(h)(3)–(5) of the Act; (4) On exempt boards of trade operating pursuant to Section 5d of the Act; and (5) On foreign boards of trade. Regulation 18.05 further provides that every such trader shall also keep books and records showing all details concerning all positions and transactions in the cash commodity, its products and byproducts, and all commercial activities that the trader hedges in the futures or option contract in which the trader is reportable and that the trader shall upon request furnish to the Commission any pertinent information concerning such positions, transactions, or activities in a form acceptable to the Commission.

[27] Each recipient of the special call was given the following warning: "Any person who knowingly and willfully makes false or fraudulent statements, whether under oath or otherwise in the course of a Commission investigation, or who falsifies, conceals, or covers up a material fact, or submits any false writing or document, knowing it to contain false, fictitious, misleading, materially incomplete, or fraudulent information, is subject to the criminal penalties listed in 18 U.S.C. § 1001, which provides for imposition of a substantial fine under the Federal Sentencing Guidelines, imprisonment of not more than five years, or both, for such conduct."

The special call required all entities to provide data for month-end dates beginning December 31, 2007, and continuing through June 30, 2008. The special call is on-going, and the entities have a continuing obligation to provide data for each month-end date by the 5th business day after the "as of" date.[28] The special call required production of the following information:

- From commodity index traders, the total notional value of their commodity index business, with a breakout of how much of that notional value is based upon commodities in the index that are traded on U.S. markets versus non-U.S. markets, and separately for each commodity in the index that is traded on a U.S. DCM, notional values and the estimated equivalent number of futures contracts[29] (regardless of whether the futures position is actually carried and cleared at the DCM or has been internally netted by the responder).

- From commodity index funds and swap dealers reporting the commodity-index portion of their swap books, a classification, in aggregate form, of their index clients as "index funds," "institutional accounts," "sovereign wealth funds," or "other."[30]

- From commodity index funds, the extent to which their market exposure was gained (1) by holding positions directly in the component futures markets and (2) by positions held through OTC commodity swap agreements or other derivative transactions.

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[28] Pursuant to a Memorandum of Understanding on information sharing between the Commission and a foreign futures regulator, the Commission enlisted the assistance of the foreign regulator in obtaining data from two entities with a non-U.S. parent firm located in that foreign jurisdiction.

[29] Each futures contract has a notional value (essentially the price per unit times the number of units in the contract, e.g., for wheat, the notional value of 1 futures contract is 5000 bushels times the price per bushel). If one knows the total notional value invested in a futures commodity, one can calculate an equivalent number of futures contract. Vice versa, if one knows the total number of futures contracts in a commodity, one can calculate the equivalent notional value. Commission staff requested that traders report a "futures equivalent" position, combining futures with delta-adjusted option positions and estimating what futures positions would have been established absent other offsets. This "would have been" feature of the call arises from the fact that a swap dealer or an index fund may cover or obtain an exposure to an index through a combination of several alternatives, included establishing futures positions in the component markets, initiating swap agreements or other OTC trades with third parties, and internal offsets or netting with other parts of the entity's business. The energy markets in particular offer an array of methods/markets to establish and offset risk, so that only asking for open, cleared futures/options positions that directly result from index trading would not be indicative of the impact of index trading on futures markets. Moreover, swap dealers routinely calculate the equivalent futures position of a swap agreement as precisely as possible to avoid net market exposure. For example, a swap on jet fuel covering several years must be converted to the present value of a hedgeable commodity—most likely heating oil—so that the dealer's risk can be offset versus on-exchange futures contracts or OTC derivatives, or be netted internally against other risk in heating oil.

[30] For this purpose, an "index fund" is defined as a client/counterparty with a fiduciary obligation to match or track the results of a commodity index, including ETFs and ETNs based upon a commodity index; an "institutional investor" is defined as a pension fund, endowment fund, or other similar investors; and a "sovereign wealth fund" is defined as a non-U.S. government entity, including, for example, a government investment company or a government-run pension fund. The "other" category is largely made up of retail investors holding ETFs, ETNs, and similar instruments that are publicly traded.

- From commodity index funds, the identities of individual clients investing $100 million or more in notional value. To put that dollar value in perspective, a $100 million notional value invested solely in NYMEX crude oil futures contracts when the price of a barrel of crude oil was $120 would be equal to fewer than 850 contracts. This criterion was intentionally set at a relatively low level so the data provided is over-inclusive rather than under-inclusive.

- From swap dealers, details of their bilateral, single-commodity swap business including, by market, the futures equivalent positions arising from swaps referenced to or hedged in a U.S. market, and in aggregate form, a classification of their single-commodity swap clients as "commercial," "noncommercial," or "intermediary."[31]

- From swap dealers, the identity of clients (whether arising from their index business or their single-commodity business) whose aggregate position across all expirations in a commodity was at or above 25 percent of the single-month position limit or accountability level for that market.[32] This criterion, like that for commodity index funds, also was set at a relatively low level in order to see more, rather than less, data. Swap dealers were directed to sum up all

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[31] For this purpose, a "commercial" means a client/counterparty who has market risk arising from physical market activities in the subject commodity, and the swap agreement is part of a risk-management strategy; "noncommercial" is a counterparty who is not using the swap relative to physical market activities; and the "intermediary" category includes clients/counterparties that are intermediaries (other swap dealers, banks, etc.) for whom the responder had no information on whether they are acting on behalf of noncommercial or commercial clients. The intermediary category is substantial in many markets, but is often relatively balanced between long and short exposure. In many cases, the intermediary counterparty to a single-commodity swap is another swap dealer who was also subject to the special call. Thus, the Commission may very well be including the ultimate client in these data. For example, Dealer #1 customizes a swap for an airline for part of its fuel requirements for a 5-year period—the swap payouts are referenced to the NYMEX heating oil market. Dealer #1 offsets the risk by doing a swap with Dealer #2, who in turn offsets the risk by putting on heating oil futures contracts on NYMEX. If both dealers were subject to the special call, which was usually the case, Dealer #1's response to the special call would show its commercial counterparty (the airline) with an estimated long position in heating oil futures and an intermediary counterparty (Dealer #2) with an estimated short position in heating oil futures. Dealer #2's response to the special call would show an intermediary counterparty (Dealer #1) with an estimated short position in heating oil futures. In this case, when summed up across the dealers subject to the call, the intermediary category would net to something close to zero and the commercial category would show the position in heating oil that offsets the airline's risk management. More complex cases might involve a number of swap dealers as intermediaries, including a swap dealer that wants to trade a heating oil risk for a risk in another energy derivative product or risk over a different time period or location—U.S. versus European.

[32] It is important to note that "positions" reported are not necessarily the same as futures and option positions held in the name of the client/counterparty. In the case of a swap dealer, the counterparty position may be offset against another OTC counterparty, offset through a non-U.S. exchange, or offset or netted internally with other parts of the dealer's business.

the business they do with a client and entities under common ownership (10 percent or greater financial interest) or control to determine if that client met the 25 percent threshold.[33]

In total, data from the special call identified about 550 individual clients that met the threshold criteria in one or more markets.[34]

B. Potential Limitations of the Special Call

The special call was issued only to traders that hold reportable futures positions. This does not appear to impose a serious limitation because large swap dealers are also likely to be substantial futures traders. While there are ways that investors can gain exposure to commodities markets without being subject to Commission reporting requirements, such trading activity is likely reflected in the special call data in other ways. Sponsors of ETFs and ETNs that base their return on an index of commodities, for example, may go directly to futures markets or through swap dealers to gain market exposure. To the extent either method represents a substantial notional value, it will show up in the special call data. A mutual fund that tracks a commodity index (such as the "PIMCO Commodity Real Return Strategy Fund" and the "Oppenheimer Commodity Strategy Total Return Fund") may have certain tax or other

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[33] Swap dealers were instructed to apply the 25 percent threshold as follows: add up all of the client's futures equivalent exposure gross long and short across all expiration months in a market, and then compare each of the gross long and gross short in that market to 25 percent of that market's single-month position limit or accountability level. For example, in NYMEX WTI crude oil, the single-month accountability level is 10,000 contracts net long or short and 25 percent of that is 2,500 contracts. If a dealer has a client that is equivalent to 1,000 long in the August future, 1,500 short in the September future, and 2,000 long in the October future, then their gross exposure (3,000 long and 1,500 short) meets the reporting criteria of 2,500 contracts, even though the position in any one futures month was less than 25 percent of the single-month accountability level.

[34] All the individual client/counterparties that were reported were then matched against the Commission's large-trader reporting system to determine whether any entity was also identified in the Commission's large-trader reporting system and held concurrent futures or options positions in the same commodity in their own name. Any outright futures equivalent positions (i.e., futures plus futures-equivalent options) held in the trader's own name were then aggregated with any estimated futures positions attributed to the client by one or more of the dealers or index funds responding to the special call. This aggregate position was then compared to the actual single-month and all-months-combined position limits or accountability levels to determine the extent to which traders may be acquiring the equivalent of large positions—above the limits/levels—that would not otherwise be observable by the Commission or the exchanges.

considerations that limit its direct investment in futures,[35] but to the extent it has a substantial notional value, it will show up in the special call data, likely as a client of a swap dealer.[36]

Just as this type of special call was unprecedented for the Commission and the staff, it was equally unprecedented for the recipients. Entities receiving a request were asked to provide data, under tight deadlines, of a type and in a form that would be useful to the Commission staff, which was typically not consistent with how the firms kept their records. Some entities re-filed at least part of their data several times, as recently as during the week of September 1, which required updates to the already compiled data and analysis.

5. Findings

In analyzing the monthly data received for the first 6 months of 2008 and preparing these findings, staff focused their analysis on three quarterly snapshots – as of December 31, 2007, March 31, 2008, and June 30, 2008. Given the volume of data received and analyzed, and in order to meet the announced September 15, 2008 deadline to provide this information to Congress, staff focused on providing three snapshots of the data rather than monthly analysis. In addition, the findings below highlight four key markets—the NYMEX WTI crude oil contract, the CBOT soft red wheat and corn contracts, and the ICE Futures-U.S. cotton contract, and make some general observations about other major markets. The findings do not equally highlight all the markets for which data was requested because again, time constraints would not allow staff to conduct the detailed analysis of all markets.[37]

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[35] For example, PIMCO Funds, in a supplemental filing with the Securities and Exchange Commission concerning their Commodity Real Return Strategy Fund (6/29/06), states that, "[b]ased on Revenue Ruling 2006-31, IRS guidance and advice of counsel, the Fund will seek to gain exposure to the commodity markets primarily through investments in commodity index-linked notes. However, the Fund will continue to seek ways to make use of other commodity-linked derivative instruments, including swap agreements, commodity options, futures and options on futures, and alternative structures within the Fund to gain exposure to commodity markets."

[36] By contrast, single-commodity ETFs, such as "streetTracks Gold Trust" (the largest such investment vehicle) and the "iShares Silver Trust," hold physical bullion and are not a part of this study.

[37] Crude oil is featured because this special call was initially undertaken as part of several energy market initiatives announced on May 29, 2008 - the largest and most notable of those markets is the NYMEX WTI crude oil market. The agricultural commodities featured in these findings were all subject to discussion at the Commission's April 22, 2008 Agricultural Forum. The CBOT soft red wheat futures contract, the CBOT corn futures contract, and ICE Futures-U.S. cotton are featured because these three markets all are subject to Federal speculative position limits, and they are included in the 12 agricultural markets for which the Commission publishes data on index trading. Further, from among those 12 agricultural markets, the CBOT wheat market has consistently had one of the highest percentages of index trading with gross long positions of index traders in CBOT wheat futures and options combined averaging about 41 percent of open interest over the first 6 months of 2008. Moreover, the CBOT corn market has consistently had the highest number of futures contracts devoted to index trading. The ICE Futures-U.S. cotton market is also included because of the unprecedented market conditions and concerns expressed by market participants with respect to the February/March 2008 price run-up.

It is important to remember that these figures do not represent the amount of trades that were brought to the regulated futures exchanges since a significant amount of these positions are "netted" internally by swap dealers. These "look behind" figures represent the OTC book of swap dealers and not the "netted" amount that is ultimately managed in the futures markets.

A. Notional Value of Commodity Index Trading

For each of the above-mentioned quarterly dates, the net notional value[38] of commodity index trading, which includes the portfolios held by swap dealers doing index business with their counterparties, plus the notional value of positions held by index funds trading directly on exchanges, was reported to be:

December 31, 2007:	$146 billion;
March 31, 2008:	$168 billion; and
June 30, 2008:	$200 billion.

Approximately 20 percent of the net notional value of commodity index trading on each of those dates was tied to commodities traded on non-U.S. markets, with the remainder tied to commodities traded on U.S. markets regulated by the Commission (DCMs).[39] As such, the net notional value of the portion of commodity index trading tied to commodities traded on U.S. markets was reported to be:

December 31, 2007:	$118 billion:
March 31, 2008:	$133 billion; and
June 30, 2008:	$161 billion.

By way of comparison, on June 30, 2008, the total notional value of all futures and options open contracts for the for the 33 U.S. exchange-traded markets that are included in major commodity indexes was $946 billion.

Of the $161 billion net notional value of commodity index business in U.S. markets on June 30, 2008, about 24 percent was held by "index funds," about 42 percent was held by "institutional investors," about 9 percent was held by "sovereign wealth funds," and about 25 percent was held by "other" traders. The "other" category is largely made up of retail investors holding ETFs, ETNs, and similar instruments that are publicly traded. The percentages held by

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[38] Throughout the report, notional values and the equivalent numbers of futures contracts are provided on a net basis. During the study, we found that portfolio managers that have established a long commodity index exposure through a long-term swap agreement may establish short commodity index exposure when the commodities component of their total portfolio has grown beyond the desired percentage allocation, which was prevalent during this recent period of rising commodity prices compared to returns on other assets. These short commodity index positions offset a portion of their long exposure. As a result, the net values properly represent the size and potential impact of index investment.

[39] Most non-U.S. market commodity index trading occurs on futures exchanges in London (e.g., London Metal Exchange).

these various classes of traders appear to have been reasonably consistent over the three quarterly dates included in this study.

The 9 percent of commodity index notional value held by sovereign wealth funds was analyzed further by the types and locations of entities in that category. For clients of index funds with $100 million or more invested, four entities were identified as sovereign wealth funds: 2 separate pension funds run by a European government; 1 fund in the name of a North American government; and 1 fund in the name of a European city. None of the 4 was identified with a futures-equivalent position over a position limit or accountability level. For single-commodity clients of swap dealers, 6 entities that appear to be sovereign wealth funds were identified as above the threshold levels described earlier (i.e., total all-months gross futures equivalent position of 25 percent or more of a single-month limit or level). Three of these were North American, 1 was European, and 2 were Asian.

B. NYMEX WTI Crude Oil

Amounts of Index Trading

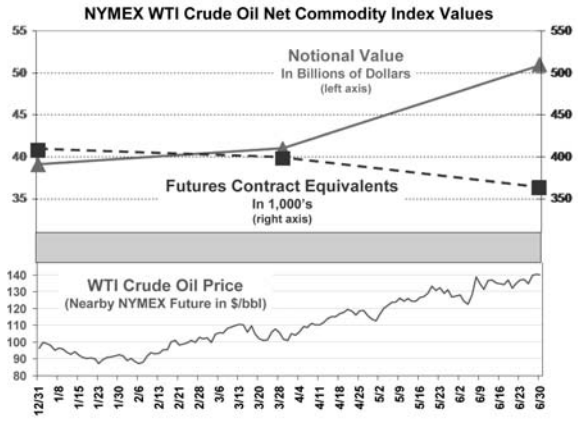
The data for NYMEX crude oil positions includes positions traded on NYMEX as well as those traded on ICE Futures Europe in London that are linked to the NYMEX crude oil contract. On the quarterly dates, NYMEX crude oil had the following amount of commodity index investment, which averaged approximately 32 percent of the total index notional value in all U.S. markets:[40]

	December 31, 2007	March 31, 2008	June 30, 2008
NYMEX Crude Oil—Index Notional Value	$39.1 billion	$41.0 billion	$51.0 billion
Crude Oil index values measured in futures equivalents	408,000	398,000	363,000
Total NYMEX Crude Oil Futures and Options Open Interest	2,508,971	2,885,101	2,837,447
NMEX Crude Oil Price	$96 bbl.	$102 bbl.	$140 bbl.

While the net notional value of commodity index business in NYMEX WTI crude oil increased sharply over the 6-month period ending on June 30, 2008—by about 30 percent, the actual numbers of equivalent long futures contracts **declined** over that same period by about 11 percent. In other words, the sharp rise in the net notional value of commodity index business in crude oil futures appears to be due to an appreciation of the value of existing investments caused

[40] The Commission does not publish Index Traders positions for WTI crude oil futures, for reasons discussed elsewhere in this report, so no direct comparisons can be made to Commitment of Traders data.

by the rise in crude oil prices and not the result of more money flowing into commodity index trading. This is illustrated in the following chart:



Types of Swap Clients

For NYMEX WTI crude oil, as of June 30, 2008, the special call covered 90 percent or more of the actual total long and the total short futures and options positions held by all of the swap dealers and represented essentially all of the index trading done through swap dealers. The special call data show that, where the principals are known to the dealer, commercial client counterparties of single-commodity swaps in crude oil held about 59 percent of the estimated futures contract equivalents on the long side and about 69 percent on the short side; while noncommercial client counterparties held about 41 percent of the estimated futures contract equivalents on the long side and about 31 percent on the short side. Here the noncommercial category includes the sum of the noncommercials identified as single-commodity swap counterparties and all of the dealer's commodity index clients (the index funds, institutional investors, sovereign wealth funds, and other).

Swap Clients Above Accountability Levels

On June 30, 2008, there were 20 swap clients identified to the CFTC with aggregate positions (all on-exchange futures positions plus all OTC positions combined, on a futures equivalent basis) exceeding the 10,000-contract single-month or the 20,000-contract all-months-combined accountability levels. Unlike position limits (which are specific limits that a trader's on-exchange position may not exceed without potentially violating the CEA), accountability levels are position levels that, if exceeded, trigger additional exchange scrutiny of the positions

and requests from the exchange for information concerning the positions, but do not preclude maintaining or adding to the position.

Of the 20 counterparties, 14 were commercial clients and 6 were noncommercial clients. There were also 10 intermediaries reported as clients above an accountability level. All of those intermediaries were separately subject to the Commission's special call and, to the extent they may have had large clients, they would have reported them.

Of the 6 noncommercial clients in crude oil who held aggregate futures plus OTC positions above the single-month or all-months-combined level, 3 held equivalent futures positions above the single-month level: a U.S. hedge fund over on the short side by 14,700 contracts; a European pension fund over on the long side by 2,600 contracts; and an Asian sovereign wealth fund over on the long side by 3,000 contracts. The remaining 3 noncommercial clients held equivalent futures positions above the all-months-combined level were—a European pension fund over on the long side by 14,600 contracts, a U.S. investment advisor with institutional clients over on the long side by 4,800 contracts, and a Canadian pension fund over on the short side by 600 contracts.

On June 30, 2008, the total of 25,000 long contracts of equivalent positions that 4 noncommercial clients had above an accountability level represented about 2 percent of the total open interest held by long noncommercial traders on-exchange and about 1 percent of total futures and options open interest for crude oil. Similarly, the total of 15,300 short contracts of equivalent positions that 2 noncommercial clients had above an accountability level represented about 1 percent of the total open interest held by short noncommercial traders on-exchange and about 0.5 percent of total futures and options open interest. NYMEX was aware of 3 of the 6 total identified noncommercial customers above accountability levels, though the NYMEX may not have known the full extent of their OTC positions.

Counting only OTC positions reported in the special call (i.e., excluding actual futures contracts held by the clients) 3 of the above-cited noncommercial clients held futures-equivalent OTC positions exceeding the accountability levels. Two exceeded the single month level by 2600 futures contract equivalents each on the long side; and 1 exceeded the all-months level by 600 futures contracts equivalents on the short side.

C. CBOT Wheat

Amounts of Index Trading

On the quarterly dates, CBOT Wheat had the following amount of commodity index investment, which averaged approximately 6% of the total index net notional value in all U.S. markets:[41]

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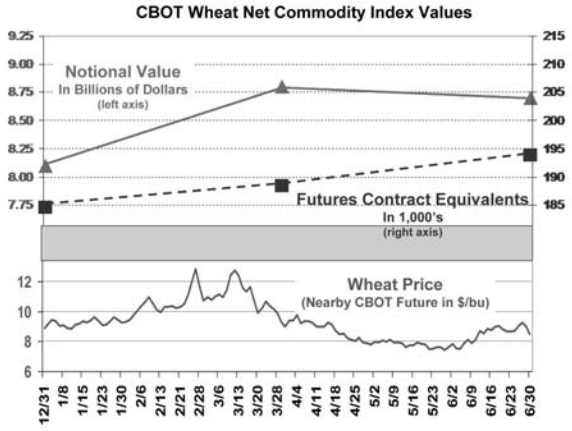
[41]By way of comparison, the weekly Commitments of Traders data published on dates nearest to the quarterly dates showed net long wheat futures equivalent positions held by Index Traders as 196,000 contracts on December 31, 2007, 178,000 contracts on April 1, 2008, and 178,000 contracts on July 1, 2008. The COT data have to be viewed ultimately as estimates of index trading, because the reported

	December 31, 2007	March 31, 2008	June 30, 2008
CBOT Wheat—Index Notional Value	$8.1 billion	$8.8 billion	$8.7 billion
CBOT Wheat Index values measured in futures equivalents	185,000	188,000	194,000
Total CBOT Wheat Futures and Options Open Interest	540,679	536,731	444,953
CBOT Wheat Price	$8.85 bu.	$9.29 bu.	$8.44 bu.

Both the net notional values and the equivalent numbers of futures contracts reported for commodity index trading in wheat changed very little over that time period. Wheat futures prices, however, experienced a great deal of volatility over the 6-month period. The nearby futures price was at around $8.85 per bushel on December 31, and traded near $13.00 in late February and early March, before declining to $8.44 at the end of June. Based upon this limited amount of data, there is no clear relationship between the small changes in numbers of futures equivalents related to commodity index business and the movement or volatility of wheat futures prices. This is illustrated in the following chart:

futures positions of swaps dealers doing index trading includes internal netting and the other business—single-commodity swaps and proprietary—that they bring to the futures markets.



Types of Swap Clients

The OTC aspect of the CBOT wheat market is very small compared to, for example, the highly developed OTC crude oil market. As of June 30, 2008, the special call data show that, where the principals are known to the dealer, commercial client counterparties of single-commodity swaps held less than 1 percent of the estimated futures contract equivalents on the long side and about 3 percent on the short side; while noncommercial client counterparties held over 99 percent of the estimated futures contract equivalents on the long side and about 97 percent on the short side. Here the noncommercial category includes the sum of the noncommercials identified as single-commodity swap counterparties and all of the dealer's commodity index clients (the index funds, institutional investors, sovereign wealth funds, and other).

Swap Clients Above Speculative Limits

On June 30, 2008, there were 7 principals identified to the CFTC with aggregate positions (all on-exchange futures positions plus all OTC positions combined, on a futures equivalent basis) exceeding either the 5,000 contract single-month or the 6,500-contract all-months-combined speculative position limits and 6 of those were noncommercial. Of those 6 noncommercial clients, 4 held futures equivalent positions above the all-months-combined limit— a European hedge fund over on the long side by 5,900 contracts, the sponsor of an ETF over on the long side by 2,400 contracts, a European pension fund over on the long side by 1,700 contracts, and a European hedge fund over on the short side by 1,100. The remaining 2 noncommercial clients held futures equivalent positions above the single-month level—a U.S. hedge fund over on the short side by 1,000 contracts, and another U.S. hedge fund over on the short side by 600 contracts. There were also 11 intermediaries identified to the CFTC as clients,

all of whom were subject to the Commission's special call. To the extent they may have had large clients, they would have reported them.

On June 30, 2008, the total of 10,000 long contracts of equivalent positions that 3 noncommercial clients had above position limits represented about 5 percent of the total open interest held by long noncommercial traders on-exchange and about 2 percent of total futures and options open interest for wheat. Similarly, the total of 1,600 short contracts of equivalent positions that 3 noncommercial clients had above an accountability level represented less than 1 percent of the total open interest held by short noncommercial traders on-exchange and was a negligible portion of total futures and options open interest.

Counting only OTC positions reported in the special call (i.e., excluding actual futures contracts held by the clients), 2 of the above-cited noncommercial clients exceeded the single month limit by 2000 and by 3900 futures contract equivalents respectively, both on the long side; amounting to the clients exceeding the all-months limit, by 500 and by 2400, respectively, both on the long side.

D. CBOT Corn

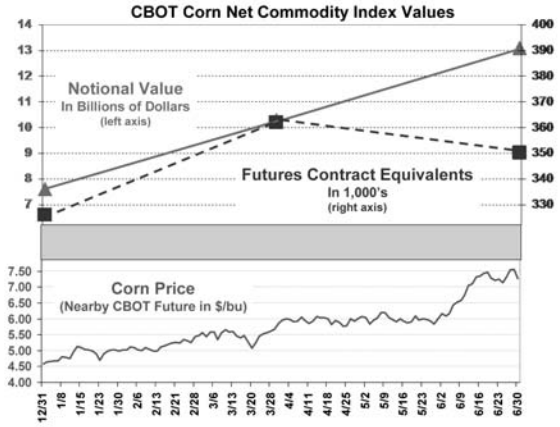
Amounts of Index Trading

On the quarterly dates, CBOT corn had the following amount of commodity index investment, which averaged approximately 7 percent of the total index net notional value in all U.S. markets: [42]

	December 31, 2007	March 31, 2008	June 30, 2008
CBOT Corn—Index Notional Value	$7.6 billion	$10.3 billion	$13.1 billion
CBOT Corn Index values measured in futures equivalents	326,000	362,000	350,000
Total CBOT Corn Futures and Options Open Interest	1,726,038	2,111,856	2,048,567
CBOT Corn Price	$4.56 bu.	$5.67 bu.	$7.25 bu.

[42]By way of comparison, the weekly Commitments of Traders data published on dates nearest to the quarterly dates showed net long corn futures equivalent positions held by Index Traders as 366,000 contracts on December 31, 2007, 439,000 contracts on April 1, 2008, and 417,000 contracts on July 1, 2008. The COT data have to be viewed ultimately as estimates of index trading, because the reported futures positions of swaps dealers doing index trading includes internal netting and the other business—single-commodity swaps and proprietary—that they bring to the futures markets.

Corn futures prices were also volatile over the 6-month period and increased sharply. The nearby futures price was at around $4.56 per bushel near January 1, closed at $5.67 on March 31, and moved even higher to about $7.25 at the end of June. The net notional values associated with commodity index trading increased significantly from December 31 to March 31 (by about 36 percent) and increased again from March 31 to June 30 (by about 27 percent). The estimated numbers of futures contracts associated with commodity index trading increased from December 31 to March 31 by about 11 percent. However, from March 31 through June 30, 2008, as the nearby futures price increased by about 28 percent, there was a net 3 percent **reduction** in the equivalent long corn futures contracts held by commodity index traders. This is illustrated in the following chart:



Types of Swap Clients

The OTC aspect of the CBOT corn market is also very small compared to the highly developed OTC crude oil market. As of June 30, 2008, the special call data show that, where the principals are known to the dealer, commercial client counterparties of single-commodity swaps held about 1 percent of the estimated futures contract equivalents on the long side and about 13 percent on the short side; while noncommercial client counterparties held about 99 percent of the estimated futures contract equivalents on the long side and about 87 percent on the short side. Here the noncommercial category includes the sum of the noncommercials identified as single-commodity swap counterparties and all of the dealer's commodity index clients (the index funds, institutional investors, sovereign wealth funds, and other).

Swap Clients Above Speculative Limits

On June 30, 2008, there was 1 principal identified to the CFTC with aggregate positions (all on-exchange futures positions plus all OTC positions combined, on a futures equivalent basis) exceeding either the 13,500-contract single-month or the 22,000-contract all-months-combined speculative position limits. This principal was a commercial client. There were also 9 intermediaries reported as clients, all of whom were subject to the Commission's special call. To the extent they may have had large clients, they would have reported them.

E. ICE Futures-U.S. Cotton

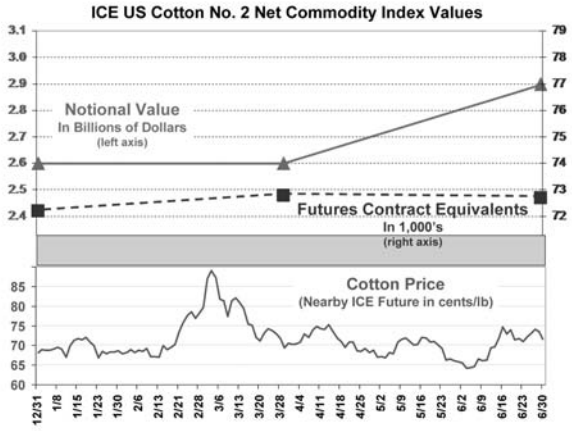
Amounts of Index Trading

On the quarterly dates, ICE-Futures cotton had the following amount of commodity index investment, which averaged approximately 2 percent of the total index net notional value in all U.S. markets: [43]

	December 31, 2007	March 31, 2008	June 30, 2008
ICE-Futures Cotton—Index Notional Value	$2.6 billion	$2.6 billion	$2.9 billion
ICE-Futures Cotton index values measured in futures equivalents	72,000	73,000	73,000
Total ICE-Futures Cotton Futures and Options Open Interest	369,243	537,132	380,560
ICE-Futures Cotton Price	$.68 lb.	$.69 lb.	$.71 lb.

In the context of a highly volatile period of time for the cotton futures market, there were only small changes in the notional values of commodity index trading and equivalent futures contracts over the 6-month time period. This is illustrated by the following chart:

[43]By way of comparison, the weekly Commitments of Traders data published on dates nearest to the quarterly dates showed net long cotton futures equivalent positions held by Index Traders as 99,000 contracts on December 31, 2007, 109,000 contracts on April 1, 2008, and 105,000 contracts on July 1, 2008. The COT data have to be viewed ultimately as estimates of index trading, because the reported futures positions of swaps dealers doing index trading includes internal netting and the other business—single-commodity swaps and proprietary—that they bring to the futures markets.



Types of Swap Clients

The OTC aspect of the ICE-Futures cotton market is also very small compared to the highly developed OTC crude oil market. As of June 30, 2008, the special call data show that, where the principals are known to the dealer, commercial client counterparties of single-commodity swaps held less than 1 percent of the estimated futures contract equivalents on the long side and about 4 percent on the short side; while noncommercial client counterparties held over 99 percent of the estimated futures contract equivalents on the long side and about 96 percent on the short side. Here the noncommercial category includes the sum of the noncommercials identified as single-commodity swap counterparties and all of the dealer's commodity index clients (the index funds, institutional investors, sovereign wealth funds, and other).

Swap Clients Above Speculative Limits

On June 30, 2008, three principals were identified to the CFTC with aggregate positions (all on-exchange futures positions plus all OTC positions combined, on a futures equivalent basis) exceeding either the 3,500-contract single-month speculative position limit or the 5,000-contract all-months limit in cotton. One was a commercial client, 2 were noncommercial clients. One of the 2 noncommercial clients, the sponsor of an ETF, held an equivalent long futures position above the one single-month limit by 1,100 contracts. The second noncommercial client, a European hedge fund, held an equivalent long futures position above the all-months limit by 6,000 contracts. There were also 4 intermediaries reported as clients. All 4 were subject to the Commission's special call. To the extent they may have had large clients, they would have reported them.

On June 30, 2008, the total of 7,100 long contracts of equivalent positions that two noncommercial clients had above speculative position limits represented about 4 percent of the total open interest held by long noncommercial traders on-exchange and about 2 percent of total futures and options open interest for cotton. Counting only OTC positions reported in the special call (i.e., excluding actual futures contracts held by the clients), the same two non-commercial swap clients exceeded the single-month limit, by 1100 and by 4600 respectively, both on the long side; and one of them exceeded the all-months limit, by 3100 on the long side.

F. Other Commodity Findings

NYMEX Natural Gas

On June 30, 2008, 32 principals were reported as holding aggregate futures and OTC positions above the single-month or the all-months-combined accountability level. Of those, 24 were commercial clients. Of the 8 noncommercial clients in natural gas, 2 held equivalent futures positions above the single-month level (of 6,000 contracts)— a U.S. investment advisor with institutional clients was over on the long side by 1,400 contracts and a European pension fund was over on the long side by 750 contracts. Six noncommercial natural gas traders held equivalent futures positions above the all-months-combined level (of 12,000 contracts)—a high net worth U.S. energy trader was over on the long side by 18,200 contracts, another high net worth U.S. investor was over on the long side by 6,600 contracts, a third high net worth U.S. investor was over on the long side by 5,200 contracts, a U.S. hedge fund was over on the short side by 4,700 contracts, a U.S. hedge fund was over on the short side by 2,200 contracts, and another U.S. hedge fund was over on the short side by 2000 contracts. Counting only OTC positions reported in the special call (i.e., excluding actual futures contracts held by the clients), 4 of the above-cited clients held positions exceeding the single-month accountability level (by 11100 long; 2400 short; 6700 long; and 10800 long); and 3 of them exceeded the all-months accountability level (by 5100; 700; and 4800; all on the long side).

CBOT Soybeans

On June 30, 2008, 3 noncommercial principals each held aggregate futures and OTC positions exceeding a position limit—a European hedge fund held a long equivalent position above the all-months-combined limit (of 10,000 contracts) by 200 contracts. The other 2 noncommercial traders held equivalent long futures positions that were above the single-month limit (of 6,500 contracts)— a U.S. investment advisor with institutional clients was over on the long side by 3,100 contracts and an Asian hedge fund was over on the long side by 1,300 contracts. Seven intermediaries in soybeans were reported as clients above the limits, but all were subject to the Commission's special call. Counting only OTC positions, none of the above exceeded limits.

ICE Futures-U.S. Sugar #11

On June 30, 2008, 4 commercial and 2 noncommercial principals each held aggregate futures and OTC positions exceeding an accountability level. Of the 2 noncommercial clients, a European hedge fund held a long equivalent position above the all-months-combined level (of 15,000 contracts) by 10,400 contracts, and the sponsor of an ETF had a short position above the all-months-combined level by 500 contracts. Nine intermediaries in sugar were reported as clients above an accountability level, but all were subject to the Commission's special call. Counting only OTC positions, the same two noncommercial swap clients exceeded the all-months limit by 500 and 4200 respectively, both on the long side.

6. Preliminary Recommendations

This special call survey of swap dealers and commodity index traders has revealed the complexity of the OTC markets, the difficulty of determining precisely the nature, size, and scope of OTC commodity swap transactions, and the challenges associated with extracting meaningful market information from such a substantial and non-standardized OTC data set. The CFTC's market oversight staff was charged with the formidable task of unraveling and analyzing the multi-billion dollar portfolios of numerous major swap dealers and assessing, to the extent possible, the impact of this type of derivatives trading on the price discovery process on futures exchanges.

While certain key findings can be drawn from the resulting data, the limitations of the scope of the survey and the relatively narrow time period of review suggest the need for continued information and analysis. Nevertheless, while highlighting the need to proceed cautiously in light of the serious difficulties in drawing meaningful market information from the large and non-standardized OTC marketplace, the Commission believes, at a minimum, that certain constructive steps can and should be taken in light of the results of this survey, and approved the following preliminary recommendations,[44] several of which may benefit from legislative codification. Of course, the Commission will consider whether further recommendations are necessary as this survey and analysis continues.

Enhanced Transparency and Data Accuracy

This survey demonstrates a need for greater transparency in the manner and amount of trading that occurs through swap dealers. Transparency is healthy both for regulatory monitoring and for market integrity and public reporting. Accurate information also is critical to making appropriate regulatory and policy decisions. Accordingly, the Commission recommends the following steps to enhance transparency, increase understanding of market activity, and improve the agency's data collection and reporting procedures.

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[44] *But see* Dissent of Commissioner Bart Chilton, Appendix G.

1. Remove Swap Dealer from Commercial Category and Create a New Swap Dealer Classification for Reporting Purposes: In order to provide for increased transparency of the exchange-traded futures and options markets, the Commission has instructed the staff to develop a proposal to enhance and improve the CFTC's weekly COT reports by including more delineated trader classification categories beyond commercial and noncommercial, which may include at a minimum the addition of a separate category identifying the trading of swap dealers.[45] The Commission believes that creating a separate stand-alone reporting category for swap dealers out of the commercial category will facilitate better understanding of the operation of and developments in the futures and options markets.

2. Develop and Publish a New Periodic Supplemental Report on OTC Swap Dealer Activity: In order to provide for increased transparency of OTC swap and commodity index activity, the Commission has instructed the staff to develop a proposal to publish a periodic supplemental report on swap dealer activity. This new report will allow for a better understanding of the exchange traded swap dealer activity that will be separately reported in the enhanced weekly COT report discussed above. It will provide a periodic "look through" from swap dealers to their clients and identify the types and amounts of trading occurring through these intermediaries, including index trading.

3. Create a New CFTC Office of Data Collection with Enhanced Procedures and Staffing: The CFTC strives to provide the public with the most accurate aggregate data possible when publishing its weekly COT reports – consistent with the inherent limitations of the current trader classification system and the agency's resources. In order to enhance the agency's data collection and dissemination responsibilities, the Commission has instructed its staff to develop a proposal to create a new office within the Division of Market Oversight, whose mission is to collect, verify, and audit information related to large trader data and certain other market information and to maintain responsibility for publication of the agency's COT reports and other periodic public reports. The Commission also has instructed the staff to review its policies and procedures regarding data collection and to develop recommendations for improvements. The Commission believes that the creation of this new office and the accompanying policy review will improve the consistency and accuracy of the agency's data collection, classification, and publication processes.

4. Develop "Long Form" Reporting for Certain Large Traders to More Accurately Assess Type of Trading Activity: As swap dealers and other large traders on regulated futures exchanges conduct a mix of both commercial and noncommercial activity, the current "either/or" classification system for commercial and noncommercial entities has become less useful and meaningful. This imprecision has led to significant misunderstandings about the nature and scope of participation in the futures markets. Because of this ambiguity in classification categories, it is difficult and unreliable for the CFTC to make estimates on the true nature of transactions occurring on exchanges without improvements to the current system. As a result, the Commission has instructed the staff to develop a supplemental information form for certain

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[45] Any new classifications and data in the COT reports would be subject to the requirements of CEA Section 8 prohibiting the publication of data and information that would separately disclose the business transactions or market positions of any person. 7 USC 12(a).

large traders on regulated futures exchanges that would collect additional information regarding the underlying transactions of these traders so there is a more precise understanding of the type and amount of trading occurring on these regulated markets.

Enhanced Controls on Swap Dealer Trading Activity

The survey has shown that swap dealers represent an amalgam of both commercial and noncommercial interests, depending on the type of commodity being traded. This mix of commercial and noncommercial activity by swap dealers calls into question whether swap dealers should receive commercial hedge exemptions from speculative position limits for some activity that is characterized as noncommercial. While the total number of noncommercial aggregate positions (all on-exchange futures positions plus all OTC equivalent futures positions) exceeding exchange position limits or accountability levels were quite small compared to the overall size of the futures markets, the Commission recommends—as a matter of regulatory consistency and fairness—the following step:

5. Review Whether to Eliminate *Bona Fide* Hedge Exemption for Swap Dealers and Create New Limited Risk Management Exemptions: The Commission has instructed the staff to develop an advance notice of proposed rulemaking that would address whether to eliminate the *bona fide* hedge exemption for swap dealers and replace it with a limited risk management exemption that is conditioned upon, among other things: (1) an obligation to report to the CFTC and applicable self regulatory organizations when certain noncommercial swap clients reach certain position levels in related exchange traded contracts, and/or (2) a certification that none of a swap dealer's noncommercial swap clients exceed specified position limits in related exchange-traded contracts. While more information is needed to fully evaluate this recommendation, requiring swap dealers to monitor and restrict the position sizes of their counterparty traders, subject to CFTC reporting and audits, as a condition of obtaining and maintaining such an exemption, is a practicable way of ensuring that noncommercial counterparties are not purposefully evading the oversight and limits of the CFTC and exchanges, and that manipulation is not occurring outside of regulatory view.

Increased Funding

6. Additional Staffing and Resources: The Commission believes that substantial additional resources will be required to successfully implement the above recommendations. The CFTC devoted more than 30 employees and 4000 staff hours to this survey, which the Commission is now recommending to produce on a periodic basis. Other new responsibilities will also require additional staff time and resources. The agency has currently been operating at or near historically low staffing levels. Accordingly, the Commission respectfully recommends that Congress provide the CFTC with funding adequate to meet its current mission, the expanded

activities outlined herein, and any other additional responsibilities that Congress asks the CFTC to discharge.[46]

Other Recommendations

7. Encourage Clearing of OTC Transactions: The Commission believes that market integrity, transparency, and availability of information related to OTC derivatives are improved when these transactions are subject to centralized clearing. Accordingly, the Commission will continue to promote policies that enhance and facilitate clearing of OTC derivatives whenever possible.

8. Review of Swap Dealer Commodity Research Independence: Many commodity swap dealers are large financial institutions engaged in a range of related activity, including commodity market research. Questions have been raised as to whether swap dealers' futures trading activity is sufficiently independent of any related and published commodity market research. Accordingly, the Commission has instructed the staff to utilize existing authorities to conduct a review of the independence of swap dealers' futures trading activities from affiliated commodity research, and report back to the Commission with any findings.

[46] For purposes of this report, the Commission has not set forth specific resource and staffing estimates for any of the proposed recommendations. However, the Commission stresses its willingness to assist Congress by providing specific budgetary estimates related to these recommendations as necessary.

Appendix A

COMMODITY INDEX INVESTMENT

Net Notional Value Reported by Call Responders
(Billions of US Dollars)

US Futures Market (Notional Value > 0.5 billion US$)*	31-Dec-07	31-Mar-08	30-Jun-08
Cocoa	0.4	0.5	0.8
Coffee	2.2	2.4	3.1
Copper COMEX	2.8	4.4	4.4
Corn	7.6	10.3	13.1
Cotton	2.6	2.6	2.9
Feeder Cattle	0.4	0.5	0.6
Gold	7.3	8.3	9.0
Heating Oil	7.8	7.7	10.0
Lean Hogs	2.1	2.9	3.2
Live Cattle	4.5	5.0	6.5
Natural Gas	10.8	13.3	17.0
RBOB Gasoline	4.5	6.2	8.0
Silver	1.8	2.4	2.3
Soybean Oil	2.1	2.0	2.6
Soybeans	8.7	8.2	10.9
Sugar	3.2	4.5	4.9
Wheat (CBOT)	8.1	8.8	8.7
Wheat (KCBOT)	1.2	1.0	1.0
WTI Crude Oil	39.1	41.0	51.0
Subtotal (> 0.5 billion US$)	**117.2**	**132.0**	**160.1**
Subtotal (< 0.5 billion US$)	**0.7**	**0.8**	**1.4**
Total US	**117.9**	**132.8**	**161.5**
Total NON-US	**28.1**	**34.8**	**38.4**
Total Notional Value	**146.0**	**167.6**	**199.9**

34 swaps dealers and index funds responded with notional value data for commodity index business

* US Futures Markets with greater than 0.5 billion US dollars in reported index investment notional value at the end of at least one month (December, March, or June).

Appendix B

The Purposes of Futures Trading on DCMs: Hedging and Price Discovery

An exchange-traded futures contract is an agreement between two parties to buy and sell a given amount of a commodity at an agreed upon date in the future, at an agreed upon price and at a given location.[47] Such contracts are primarily designed to manage risk and, as a result usually are extinguished without physical delivery by exchange style offset or, depending on the contract, cash settlement. Their terms and conditions usually are identical in all aspects except for the contracted price; and the trades are cleared through designated clearinghouses. The standardization and clearing of such futures contracts make the contracts fungible, which allows for easy offset and enhances trading. That is, every exchange-traded futures contract for a particular commodity is the same as any other contract, and because the clearinghouse is the counterparty to every contract, there is no need for a party to go back to the original contracting party to offset a position—the holder of a futures contract simply enters into a new contract opposite that of the first to cancel the obligation.

The standardization and tradability of exchange-traded futures contracts also facilitate risk management because a hedger can obtain a price exposure to a well-defined commodity (in terms of commodity specification and delivery location) that tends to correlate in a known way with the price he/she is trying to hedge. However, standardization also means that the price risk the hedger is hedging, and the terms specified in the contract may not match precisely (particularly with respect to delivery location). The offset feature of futures contracts means that a hedger will typically not deliver or take delivery of the commodity, opting instead to take a financial settlement of the contract that may mitigate the effect of losses realized in the cash market. Indeed, a vast majority of futures contracts do not result in delivery. It is the threat of delivery that serves the purpose of keeping the cash and futures prices aligned.

Due to contract standardization, exchange-traded futures contracts are not generally suited, or used, to merchandise the physical commodity. For example, to serve a significant merchandising role, such contracts would need to offer multiple locations of physical delivery with a variety of grades or qualities to match the diverse needs of numerous buyers and sellers of the commodity. Such a variety of contract specifications, however, would make the trading of

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[47] For example, the CBOT December 2008 corn contract is an agreement to deliver 5,000 bushels of No. 2 yellow corn via a shipping certificate within the Chicago and Burns Harbor, Indiana shipping districts along the Illinois waterway during the first half of December 2008. In the case of crude oil, the NYMEX WTI December 2008 oil contract is an agreement to physically deliver 1,000 barrels (42,000 gallons) of oil at Cushing, Oklahoma during the contract month. For all futures contracts there is a buyer and a seller. The buyer (or long trader) and the seller (or short trader) agree to a price when they enter into the contract. If the contract provides for physical delivery of a commodity, a party whose contract remains open at its expiration date (i.e. not offset) is obligated to make or take delivery as promised. Not all futures contracts require physical delivery. Some futures contract provide for cash settlement at contract expiration, whereby a cash price or other price is used to value the gains or losses on a contract. For example, the CME uses the CME Feeder Cattle Index to settle its feeder cattle futures contract. The index is a seven-day weighted average of USDA prices from a 12-state region.

the contracts unwieldy due to the uncertainty of what would be delivered on the contract and where. As a result, the designers of on-exchange contracts strive to create contracts that are reflective of the general characteristics of the physical markets, while leaving the role of merchandising the actual commodity to the cash markets. The cash markets include the spot market, where transactions involve immediate or near term delivery and payment for the commodity; and forward contracts where delivery and payment are deferred for reasons of commercial convenience or necessity.

Because most exchange-traded futures contracts are standardized in all respects other than price, futures markets are ideal for aggregating a multiplicity of opinions about the expected price of a commodity at different points in time. For that reason, futures markets are an important source of price information—prices are often said to be "discovered" in futures markets and then communicated to participants in cash markets who may choose to use futures prices as the basis for their transactions.

The price discovery function of futures markets is extremely valuable for commercial enterprises in terms of planning business activities and for allocating resources. The availability of publicly observed futures prices for several years into the future makes it possible to recognize, plan, and finance needed business adjustments in supply and demand early on. This, in turn, may help reduce price volatility. Price volatility is often higher in markets without a successful exchange-traded futures contract, such as those for fertilizers, coal, tea and onions.[48]

[48] For example, while onion futures contracts are explicitly banned by law, it has been observed that the cash price for onions rose 400 percent between October 2006 and April 2007, fell 96 percent by March 2008, and then rebounded 300 percent by April 2008.

Appendix C

Speculation and Price Discovery in Futures Markets

1. Hedgers and Speculators

As passive commodity index trading has become more attractive as an investment alternative, many in the private and public sectors have expressed a concern that the amount of these "long only" investments may be artificially driving prices higher over the long run or blunting the effects of supply and demand. Questions have been raised whether this activity may be overwhelming traditional commercial interests that have used these markets to hedge their business activities.

While hedging and speculation are typically thought of as distinct and opposite activities in the futures markets, this swap dealer survey has made clear that the distinction in practice may be much less clear. Traditionally, those with a commercial interest in or an exposure to a physical commodity have been called hedgers, while those without such an exposure have been called speculators. In practice, however, some hedgers may be "taking a view" on the price of a commodity beyond their hedging needs.

Traditional speculators enter into futures contracts with the intention of reversing their positions before they would be required to deliver (short positions) or to accept physical delivery (long positions) of a commodity. As such, speculators serve important market functions – immediacy of execution, liquidity, and information aggregation.

Traditional speculators can further be differentiated depending on the time horizons at which they operate. Speculators known as "scalpers" or "market makers," operate at the shortest time horizon – sometimes trading in and out of a position within a single second. These traders typically do not trade with a view as to where prices are going. Instead, they provide immediacy of execution to a trade. That is, they "make markets" by standing ready to buy or sell at a moment's notice. These market makers will usually offset their positions soon after entering into them. The goal of a market maker is to buy contracts at a slightly lower price than the current market price and sell them at a slightly higher price (or vice versa), perhaps at only a fraction of a cent profit on each contract. By trading hundreds or even thousands of contracts a day, skilled market makers can earn a profit. Absent a market maker, a commercial market participant would have to wait until the arrival of another commercial party with an opposite trading interest.

Other types of speculators take longer-term positions based on their view of where prices may be headed. Speculators known as "day traders" establish positions based on their view of where prices might be moving in the next minutes or hours, while "trend followers" take positions based on price expectations over a period of days, weeks or months. Through their efforts to gather information on underlying commodities, the activity of these traders serves to bring information to the futures markets and to aid in price discovery. These speculators are also important to the futures markets in that they often supply overall liquidity to hedgers.

Finally, a new class of speculator—commodity index traders—has emerged in the futures markets that does not necessarily take a view on expected prices, but seeks to capture a commodity exposure that will diversify a portfolio. Traditionally, portfolio managers have sought to hold a diverse set of stocks and bonds to smooth out the performance of the portfolio. For example, the manager may invest in stocks of companies in different industrial sectors (such as manufacturing, agriculture, mining and service) on the assumption that when one sector falters, others will rise. This diversification is important to the portfolio manager because there is usually a steady stream of redemptions on the portfolio—e.g., to pay pensions or insurance claims—that must be paid out from the assets. If a portfolio is not diversified, the manager could be faced with the situation of paying out redemptions from negative earnings. As discussed above, managers have achieved an additional level of diversification on their portfolios by turning to commodities investment via an index of commodities. Whether done directly or indirectly, through swap dealers or various forms of index funds, that investment takes the form of long futures positions in the various commodities that make up the index. Futures positions must be rolled from one contract to the next as contracts near their expiration months. The typical index trader will roll the position prior to the delivery period to avoid becoming involved in the delivery process.

2. Speculative Position Limits

Historically, speculative position limits have been one of the tools used by the Commission and exchanges to prevent manipulation by controlling the size of positions held by noncommercial entities that do not have hedging needs in the underlying physical markets. These position limits require all traders to have positions below a specified level during different periods of trading unless the trader has received a hedge exemption from either the Commission or the exchange. This is meant to lessen the likelihood that a trader can obtain a large enough position to manipulate the market. Commercial entities with large merchandising needs have received hedge exemptions from these limits because of their need to match their futures market positions with their underlying physical commodity needs. Without such hedge exemptions, commercial entities would not be able to successfully hedge the price risk associated with their underlying commodity price risk exposure.

The statutory framework for Federal (Commission imposed and enforced) speculative position limits dates back to section 4a(a) of the CEA, first enacted in 1936. Section 4a(a) states 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 markets or derivatives transaction execution facilities, or on electronic trading facilities with respect to a significant price discovery contract, 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.

Accordingly, section 4a(a) of the Act provides the Commission with the authority to:

> 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, or on an electronic trading facility with respect to a significant price discovery contract, as the Commission finds are necessary to diminish, eliminate, or prevent such burden.

The operative terms of section 4a(a) – finding excessive speculation causing sudden or unreasonable fluctuations or unwarranted changes in commodity prices to be a burden on interstate commerce, and authorizing the Commission to fix such limits as are necessary to diminish, eliminate or prevent such burden – have remained essentially unchanged since 1936, with amendments generally taking into account additional types of trading facilities.[49]

Moving beyond Federal speculative limits, the Futures Trading Act of 1982 added new section 4a(e) to the Act. This section acknowledged the key role of exchanges in setting their own speculative position limits, by providing that "[n]othing in [section 4a] shall prohibit or impair the adoption" of exchange speculative position limits. New section 4a(e) also provided that position limits set by exchanges and approved by the Commission are subject to Commission enforcement as violations of the Act. Later, the CFMA amended the Act in 2000 to change commodities regulation from a system based on prescriptive rules to one of principles-based regulation.[50] Thus, the CFMA established designation criteria and core principles with which a DCM must comply to receive and maintain designation. Among these, Core Principle 5 in section 5(d) of the Act states:

> Position Limitations or Accountability —To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate.

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[49] In 2000, the Commodity Futures Modernization Act of 2000 (CFMA) added the reference to derivatives transaction execution facilities (DTEFs). In 2008, the CFTC's reauthorization legislation (The Food, Conservation and Energy Act of 2008, Pub. L. 110-246, 122 Stat. 1651, Title XIII) added the reference to electronic trading facilities trading significant price discovery contracts. The electronic trading facilities referred to are exempt commercial markets (ECMs) (*See*: section 2(h)(3) of the Act). Standards and procedures for determining a contract traded on an ECM to be a significant price discovery contract ("SPDC") are set out in section 2(h)(7)(B) of the Act.

[50] Section 2 of the CFMA identified the purposes of this landmark legislation as being, among other things, "to streamline and eliminate unnecessary regulation for the commodity futures exchanges and other entities regulated under the Commodity Exchange Act" and "to transform the role of the Commodity Futures Trading Commission to oversight of the futures markets."

The Commission's 2008 reauthorization legislation added similar position limitation / position accountability provisions for DTEFs and for ECMs with respect to significant price discovery contracts.[51]

3. Hedge Exemptions

As mentioned earlier, certain commercial entities have been allowed to receive hedge exemptions from speculative position limits in order to allow these entities to manage their exposure to price risk derived from their commercial businesses. The regulatory structure for speculative position limits is administered under a two-pronged framework, resulting in enforcement of speculative position limits being shared by both the Commission and the DCMs.[52]

Under the first prong, the Commission establishes and enforces speculative position limits for futures contracts on a limited group of agricultural commodities. These "Federal limits" are enumerated in Commission regulation 150.2, and apply to the following futures and option markets: CBOT corn, oats, soybeans, wheat, soybean oil, and soybean meal; Minneapolis Grain Exchange (MGX) hard red spring wheat and white wheat; ICE Futures U.S. (formerly the New York Board of Trade) cotton No. 2; and Kansas City Board of Trade (KCBT) hard winter wheat.

Under the second prong, for all other commodities, individual DCMs, pursuant to the core principles under the Act, establish and enforce their own speculative position limits or position accountability provisions (including exemption and aggregation rules), subject to Commission oversight and separate Commission authority to enforce exchange-set speculative position limits as violations of the Act. Thus, responsibility for enforcement of speculative position limits is shared by the Commission and the DCMs.

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[51] With respect to DTEFs, new section 5a(d)(4) requires DTEFs to adopt position limitations or accountability for speculators "where necessary and appropriate for a contract, agreement or transaction with an underlying commodity that has a physically deliverable supply." With respect to ECMs, new section 2(h)(7)(C)(ii)(IV) requires such electronic trading facilities to "adopt, where necessary and appropriate, position limitations or position accountability for speculators in significant price discovery contracts, taking into account positions in other agreements, contracts and transactions that are treated by a derivatives clearing organization, whether registered or not registered, as fungible with such significant price discovery contracts."

[52] Provisions regarding the establishment of exchange-set speculative position limits were originally set forth in CFTC regulation 1.61. In 1999, the Commission simplified and reorganized its rules by relocating the substance of regulation 1.61's requirements to part 150 of the Commission's regulations, thereby incorporating within part 150 provisions for both Federal speculative position limits and exchange-set speculative position limits (*See*: 64 FR 24038, May 5, 1999). With the passage of the CFMA in 2000 and the Commission's subsequent adoption of its part 38 regulations covering DCMs in 2001 (66 FR 42256, August 10, 2001), part 150's approach to exchange-set speculative position limits was incorporated as an acceptable practice under DCM Core Principle 5 – Position Limitations or Accountability.

Prior to 1974, the hedging definition, which was set forth in the CEA, applied to agricultural commodities only. In 1974, when the Commission was created and the definition of "commodity" under the Act was expanded significantly, Congress was concerned that the statutory definition would fail to address developing risk-shifting needs that were beginning to emerge at that time. Accordingly, Congress repealed the old statutory definition, and instead gave the Commission rulemaking authority to define what constituted *bona fide* hedging.

By 1977, the Commission had formulated the regulatory framework that remains in place today. The Commission's *bona fide* hedging definition consists of three parts contained in regulation 1.3(z).[53] First, regulation 1.3(z)(1), "General Definition," provides a general description of transactions or positions that the Commission considers to be *bona fide* hedging under economically appropriate circumstances. This part of the rule specifies that no transaction or position shall be classified as *bona fide* hedging for purposes of exceeding Federal speculative position limits unless, among other requirements, it can be established and liquidated in an orderly manner.

The second part of the definition, regulation 1.3(z)(2), "Enumerated Hedging Transactions," applies only to those domestically produced agricultural commodities that are subject to Federal speculative position limits. This part of the rule lists various types of futures market positions, both sales and purchases, which the Commission views as conforming to the general description in the first part of the definition. This list roughly approximates the list that was originally contained in the pre-1974 statutory definition.

The third part of the definition, regulation 1.3(z)(3), "Non-Enumerated Cases," provides that for purposes of exemptions from Federal speculative position limits, the Commission may recognize as *bona fide* hedging, purchases or sales other than those enumerated in the second part of the definition. This provision avoids potential inflexibility in the rule. It requires persons requesting a hedge exemption to provide the Commission with evidence that the transactions meet the requirements of the general definition in regulation 1.3(z)(1), and permits the Commission to specify any conditions it deems necessary to assure that the positions are consistent with orderly markets and other requirements of the Act.

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[53] 17 CFR 1.3(z).

Appendix D

Commitments of Traders Report

1. The COT Report and Changes in the Marketplace

During this period of record commodity prices, there has been an intense focus on the weekly report published by the Commission that classifies traders as either commercial or noncommercial. Specifically, some have questioned whether the historical classification of swap dealers as commercial is appropriate, given their mix of both commercial and noncommercial business.

The Commitments of Traders (COT) reports are weekly reports published by the Commission to provide a degree of transparency about activity in the futures markets. The reports are not used for market surveillance or for any regulatory purpose, including the granting of exemptions from speculative position limits. The Commission alone is responsible for preparation of the COT reports, as well as the associated classification of individual traders used in preparing the reports. Details about the underlying data and classifications are not shared with the exchanges (or traders) and, accordingly, this information does not affect the exchanges' surveillance activities or speculative position limit enforcement actions.

The COT reports show aggregate commercial and noncommercial trader positions in certain futures and options markets. The COT reports provide a breakdown of each Tuesday's open interest[54] for all futures and option markets in which 20 or more traders hold positions equal to or above the reporting levels[55] established by the Commission. The weekly reports for

[54] Open interest is the total of all futures and/or option contracts entered into and not yet offset by an opposite transaction, e.g. by delivery, by exercise (for options), *etc*. The aggregate of all long open interest is equal to the aggregate of all short open interest. Open interest held or controlled by a trader is referred to as that trader's position. For the *COT Futures & Options Combined* report, option open interest and traders' option positions are computed on a futures-equivalent basis using delta factors supplied by the exchanges. Long-call and short-put open interest are converted to long futures-equivalent open interest. Likewise, short-call and long-put open interest are converted to short futures-equivalent open interest. For example, a trader holding a long put position of 500 contracts with a delta factor of 0.50 is considered to be holding a short futures-equivalent position of 250 contracts. A trader's long and short futures-equivalent positions are added to the trader's long and short futures positions to give "combined-long" and "combined-short" positions. Open interest, as reported to the Commission and as used in the COT reports, does not include open futures contracts against which notices of deliveries have been stopped by a trader or issued by the clearing organization of an exchange.

[55] Clearing members, futures commission merchants, and foreign brokers (collectively called "reporting firms") file daily reports with the Commission. Those reports show the futures and option positions of traders that hold positions above specific reporting levels set by Commission regulations. These reporting levels range from 25 contracts for new or relatively small markets to 3,000 contracts for three-month Eurodollar time deposit rates (*See* 17 CFR 15.03). If, at the daily market close, a reporting firm has a trader with a position at or above the Commission's reporting level in any single futures month or option expiration, it reports that trader's entire position in all futures and option expiration months in that commodity, regardless of size. The aggregate of all traders' positions reported to the Commission usually

Futures-Only Commitments of Traders and for *Futures-and-Options-Combined Commitments of Traders* are released every Friday at 3:30 p.m. Eastern time. Reports are available in both a short and long format. The short report shows open interest separately by reportable and nonreportable[56] positions. For reportable positions, additional data is provided for commercial and noncommercial holdings.

The short report also provides additional data for reportable positions regarding spreading,[57] changes from the previous report,[58] percent of open interest by category,[59] and numbers of traders.[60] The long report, in addition to the information in the short report, also groups the data by crop year,[61] where appropriate, and shows the concentration of positions held by the largest four and eight reportable traders, without regard to whether they are classified as commercial or noncommercial. Current COT data are available on the internet at the Commission's website, www.cftc.gov.[62]

When a trader is first identified to the Commission by becoming reportable for a particular commodity, Commission staff classifies the trader as commercial or noncommercial

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represents 70 to 90 percent of the total open interest in any given market. From time to time, the Commission will raise or lower the reporting levels in specific markets.

[56] The long and short open interest shown as "Nonreportable Positions" are derived by subtracting total long and short "Reportable Positions" from the total open interest. Accordingly, for "Nonreportable Positions," the number of traders involved and the commercial/non-commercial classification of each trader are unknown.

[57] For the futures-only report, spreading measures the extent to which each non-commercial trader holds equal long and short futures positions. For the options-and-futures-combined report, spreading measures the extent to which each non-commercial trader holds equal combined-long and combined-short positions. For example, if a non-commercial trader in Eurodollar futures holds 5,000 long contracts and 4,500 short contracts, 500 contracts will appear in the "Long" category and 4,500 contracts will appear in the "Spreading" category. These figures do not include intermarket spreading (e.g., spreading Eurodollar futures against Treasury Note futures).

[58] Changes in commitments from the previous report represent the differences between the data for the current report date and the data published in the previous report.

[59] Percents are calculated against the total open interest for the futures-only report and against the total futures-equivalent open interest for the options-and-futures-combined report. Percents less than 0.05 are shown as 0.0, and the percents may not add to exactly 100.0 due to rounding.

[60] To determine the total number of reportable traders in a market, a trader is counted only once regardless of whether the trader appears in more than one category (non-commercial traders may be long or short only and may be spreading; commercial traders may be long and short). To determine the number of traders in each category, however, a trader is counted in each category in which the trader holds a position. Therefore, the sum of the number of traders in each category will often exceed the "total" number of traders in that market.

[61] For selected commodities where there is a well-defined marketing season or crop year, the COT data are broken down by "old" and "other" crop years.

[62] Also available at that site are historical COT data going back to 1986 for futures-only reports and to 1995 for option-and-futures-combined reports.

for that commodity. As a result, the entire trader's reported futures positions in that commodity are classified as commercial or noncommercial - it is the trading entity and the trader's futures position that are classified, **not** each individual transaction of the trader.

A trading entity generally gets classified as a commercial if the CFTC Form 40 that it is required to file with the Commission states that it is "commercially engaged in business activities hedged by the use of the futures or option markets." In order to ensure that traders are classified with accuracy and consistency, the Commission staff reviews this self-classification and may re-classify a trader if the staff has additional information about the trader's use of the markets. A trader may be classified as a commercial in some commodities and as a noncommercial in other commodities. A single trading entity cannot be classified as both a commercial and noncommercial in the same commodity. Nonetheless, a multi-functional organization that has more than one trading entity may have each trading entity classified separately in a commodity. For example, a financial organization trading in financial futures may have both a banking entity whose positions are classified as commercial and a separate money-management entity whose positions are classified as noncommercial.

COT reports are used by persons making marketing and trading decisions to analyze commodity markets, including trading activity, supply and demand, price trends, and other market factors. COT users include, among others: commercial marketing and hedging advisors and brokers (including registered futures commission merchants, introducing brokers and commodity trading advisors); cash market merchandisers/hedgers and similar decision makers, including producers, processors, end-users, merchants and exporters; and individual commodity traders/speculators. The COT reports are also used by academic and economic researchers.

One of the historical changes in the COT reports has raised questions with respect to the use of the COT data in today's market environment. Specifically, analysts have cited the COT reports as evidence of overall speculative and hedging activity in the futures markets by evaluating the breakdowns between commercial and noncommercial categories in the reports. As explained below, the current trader classifications of commercial and noncommercial are a function of historical changes in the CFTC's reporting rules.

In 1981, the Commission adopted regulations[63] to eliminate the routine filing of series '03 reports by large traders.[64] Prior to 1982, the COT reports were based on data from the series '03 reports which included both position information for all reportable traders and the traders' classification of how much of their positions was speculative and how much was hedging. Thus, the pre-1982 COT reports classified positions as either "hedging" or "speculative." In its rulemaking eliminating the series '03 reports, the Commission stated its intention to continue

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[63] 46 FR 59960 (December 8, 1981).

[64] Series '03 reports were required to be filed with the Commission by any trader who owned or controlled a reportable futures position. Once traders acquired a reportable position in a commodity, they were required to report trades, positions, exchanges of futures for physicals and delivery information regarding that commodity on series '03 reports, and to classify how much of their position was speculative and how much was hedging.

publishing the COT reports using data from the series '01 reports and Form 102,[65] as well as the Form 40, Statement(s) of Reporting Trader.[66] The Commission's decision to eliminate the series '03 forms as the basis for the COT reports improved the timing and accuracy of the COT reports because: (1) series '03 forms were mostly mailed to the Commission from wherever the trader resided, in some cases taking several days to arrive and be processed, whereas series '01 reports are filed electronically by the following morning; and (2) series '03 forms were only required to be filed when a reportable trader's position changed, so that a trader's delay or failure to file a report often led to an erroneous assumption that the position had not changed. After 1982, then reportable positions were classified as commercial or noncommercial based on the declarations made in the reporting traders' Form 40 statements.

The Commission believes that the public perception is that the "commercial vs. noncommercial" classification in current COT reports is analogous (if not identical) to the "hedging vs. speculation" distinction in the pre-1982 COT reports. Over time, however, derivatives markets (including both exchange-traded and OTC markets), as well as derivatives trading patterns and practices, have evolved tremendously. Changes have been particularly evident during the last 17 years, including the recent influx of commodity index trading. As a result of these changes in markets and trading practices, questions have been raised as to whether the commercial and noncommercial categories of today's COT reports appropriately classify trading practices that were not contemplated when the "hedging vs. speculation" categories were removed in 1982.

Based on a review of the COT reports in 2006, which included the solicitation of public comments, the Commission addressed the index trader issue by initiating publication of a new weekly report, entitled "COT—Supplemental," beginning in January 2007.[67] The COT—Supplemental report includes, in a separate category, the positions of commodity index traders in

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[65] Series '01 reports are reports filed by futures commission merchants (FCMs), foreign brokers and exchange clearing members clearing their own trades, with respect to all customer or (for the exchange clearing members) proprietary accounts that attain a reportable position. A series '01 report itemizes the account number and certain positions, deliveries and exchanges of futures (including exchanges of futures for physicals [EFPs], swaps [EFSs], risk [EFRs] and options [EFOs] or other exchanges of futures for a commodity or for a derivatives position) associated with each account carrying a reportable position (*See* 17 CFR 17.00). The name, address and occupation of the person or persons who own such accounts are separately identified on Form 102 (*See* 17 CFR 17.01). By aggregating the series '01 and Form 102 information filed with respect to traders with accounts at multiple FCMs or foreign brokers, the Commission can determine the size of each reportable trader's overall position.

[66] Each person that holds or controls a reportable position is required to file a Form 40. The Form 40 requires a trader to list its principal business or occupation and to state whether it is "commercially engaged in business activities hedged by the use of the futures or option markets." If the trader answers "yes," it is instructed to complete a separate schedule "listing the futures or option contract used, the cash commodity(ies) hedged, or the risk exposure covered, and the marketing occupations associated with hedging uses."

[67] Contemporaneously with publication of the first COT—Supplemental report, in January 2007, the Commission also published back data showing the preceding calendar year's trading information in the Supplemental report's format, in order to put the data in the Supplemental report in context and make it more understandable and useful.

certain agricultural physical commodity futures markets. These so-called "Index Traders" are drawn from both the current noncommercial and the commercial categories. Coming from the noncommercial category are managed funds, pension funds and other institutional investors that generally seek exposure to commodity prices as an asset class in an unleveraged[68] and passively-managed[69] manner using a standardized commodity index. Coming from the commercial category are entities whose positions predominantly reflect hedging of OTC transactions involving commodity indices—for example, swap dealers holding long futures positions to hedge short OTC commodity index exposure opposite institutional traders such as pension funds.

The COT—Supplemental report is restricted to selected commodity futures markets that are included in commodity indices. At this time though, the COT—Supplemental report is limited to agricultural futures markets and does not include energy or metals futures markets although they are included in commodity indices. This determination was based on an assessment of the accuracy with which this data can be parsed out for firms engaged in commodity index trading, between such index trading and other unrelated trading activity. In the case of agricultural futures markets, the futures positions of index traders generally reflected only hedges related to their index-based trades and were not significantly influenced by other, unrelated trading activity. This is becoming less true over time as shown by this survey. That is, the firms engaged in commodity index trading are also becoming engaged in more unrelated agricultural commodity trading, as the OTC markets in agricultural commodities develop.

In the case of energy and metals markets, positions of traders involved in commodity index strategies are, in many cases, overwhelmed by their unrelated trading activity involving alternative U.S. and non-U.S. exchanges and a multitude of OTC markets and derivative products. For example, many swap dealers, in addition to their commodity index-related OTC activity, enter into other OTC derivative transactions in individual commodities, both with commercial firms hedging price risk and with speculators taking on price risk. In addition, some swap dealers are very actively engaged in commercial activity in the underlying cash market, such as physical merchandising or dealing activity. The futures positions of these swap dealers represent a hedge of their net exposure, taking into account their overall long and short positions in various markets and derivative transactions. As a result, the overall futures positions held by these energy and metals traders in Commission-regulated exchanges do not necessarily correspond closely with their hedging of OTC commodity index transactions in particular. Such a swap dealer might, for example, have short exposure resulting from index-related trades (requiring a long futures position as a hedge) offset by even greater long exposure due to a commercial transaction in the underlying cash market (requiring a short futures hedge). As a result, the swap dealer would hedge its overall net exposure with a short futures position. But,

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[68] In an "unleveraged" position, the notional value of the position is fully offset by cash set aside, or by profits on the position. Therefore, financial considerations (*e.g.*, significant price changes) should not trigger rapid liquidations of the position that could lead to sudden or unreasonable fluctuations or unwarranted changes in prices.

[69] A passively managed position generally means futures or futures equivalent positions that track a broadly diversified index of physical commodities, which index is calculated, adjusted and re-weighted pursuant to an objective, predetermined mathematical formula, the application of which allows only limited discretion with respect to trading decisions.

placing that (short) futures position of such a swap dealer in a commodity index trader category would not accurately reflect its commodity index trading activity for energy and metals markets. Factors such as this complicate the Commission's ability to compile reports with respect to the role of any one trader, or category of traders, in the energy and metals futures market.

Accordingly, based on difficulties associated with reporting on trades in the energy and metals markets, the Commission decided to proceed initially with publishing the COT—Supplemental report for the following 12 agricultural commodity futures and options on the following exchanges: corn, soybeans, wheat, and soybean oil on the CBOT; wheat on the KCBOT; cotton no. 2, coffee C, sugar no. 11, and cocoa on the New York Board of Trade (now ICE Futures US); and live cattle, lean hogs, and feeder cattle on the CME. The Commission staff is confident that the classifications of traders for the COT—Supplemental report for these 12 markets are as accurate as the Commission's large-trader reporting system allows.

The new COT—Supplemental report is being published on a two-year, pilot program basis. During the course of the pilot program, the Commission is assessing the relevance and usefulness of the new data and studying whether it is possible and appropriate to expand the COT—Supplemental report to include data for other physical commodity markets. In January 2009, at the conclusion of the two-year pilot program period, the Commission will determine what further action to take with respect to the COT—Supplemental report.

Notably, the Commission's COT reports are not mentioned in, or explicitly required by, the Act. Nor is the publication of aggregate trading data specifically enumerated as one of the CEA's purposes.[70] As noted above, the COT reports are not used in the performance of any of the Commission's regulatory responsibilities. Yet, the considerable staff time and technology spent on the publication of the COT reports is time and technology that would otherwise be devoted to surveillance and other regulatory activities more clearly mandated by the Act.

2. Additional History and Evolution of the COT Reports

The COT reports trace their antecedents all the way back to 1924. In that year, the U.S. Department of Agriculture's (USDA) Grain Futures Administration, predecessor of the USDA's Commodity Exchange Authority, which is in turn the predecessor of the Commission, published its first comprehensive annual report. The report was published pursuant to the provisions of the Grain Futures Act of 1922,[71] the predecessor statute of today's Act.

The Grain Futures Administration noted that the general objectives of the Grain Futures Act included "[t]o obtain for the use of Congress and the enlightenment of the public authentic and comprehensive information regarding trading in grain futures."[72] To that end, that legislation imposed recordkeeping and reporting requirements on exchanges. One requirement

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[70] 7 USC 5(b).

[71] 42 Stat. 998, September 21, 1922.

[72] *Annual Reports of the Department of Agriculture for 1924*, *Report of the Grain Futures Administration on Administration of the Grain Futures Act*, at 2, September 9, 1924.

of the implementing regulations was that records should be made in such a manner as to show whether the persons for whom transactions were executed were "engaged in the cash grain business."[73] The express purpose of this requirement was to insure that the basic records of all transactions in grain futures would contain information that could be utilized for distinguishing transactions originating with persons engaged in the cash grain business (and therefore presumably representing in considerable part "hedging") from transactions originating with persons not so engaged (and therefore presumably representing for the most part "speculation"). The report characterized the distinction between hedging and speculation as being of "fundamental significance from the public point of view" and one that "deserves systematic reflection in the records kept of transactions in grain futures." [74]

Over the years, the Grain Futures Administration and, after 1936, its successor organization the Commodity Exchange Authority, continued to publish annual statistics concerning hedging versus speculative transactions. Beginning with the adoption of the Commodity Exchange Act in 1936, and as part of amendments to that Act on a number of subsequent occasions, the Commodity Exchange Authority's jurisdiction was expanded beyond grains to cover additional agricultural commodities. The Authority expanded its annual reports of hedging and speculative positions in futures markets to include additional commodities. [75]

In 1962, the Commodity Exchange Authority took what it called "another step forward in the policy of providing the public with current and basic data on futures market operations" by moving beyond an annual statistical recap and initiating the publication of monthly COT reports. The original COT reports were compiled on an end-of-month basis and published on the 11th or 12th calendar day of the following month. The first COT report, covering 13 agricultural commodities, was published on June 13, 1962. Over the 46 years since then, both the COT reports and the underlying futures markets have undergone a number of significant changes.

With respect to the COT reports, the number of commodities covered has continued to expand. In April 1975, the newly-formed CFTC succeeded the Commodity Exchange Authority. The Commission continued to publish the COT reports, but expanded the reports' content to include new commodities first brought under the Commission's jurisdiction by the Commodity Futures Trading Commission Act of 1974.[76] In the years since then, scores of new futures and option products have been listed for trading on designated futures exchanges. Not all of these commodities are included in the COT reports, since reports are published only for commodities in which 20 or more traders hold reportable positions. Nevertheless, the number of commodities for which the Commission publishes a report and the number of trading entities that Commission

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[73] *Id*. at 6.

[74] *Id.*

[75] In addition, starting in 1942, the Commodity Exchange Authority began issuing "Commodity Futures Statistics" as a separate publication, distinct from the USDA annual report. The Commodity Futures Statistics were also expanded to include monthly data, but were still published only on an annual basis.

[76] Pub. L. 93-463, 88 Stat. 1389, October 23, 1974. The new commodities added in 1974 included coffee, sugar, cocoa, metals, energy products and financial products, among other things.

staff must monitor and classify are quite large. In this regard, the most recent COT reports cover 110 to 120 commodities trading on seven different DCMs.[77]

In addition to expanding the number of commodities covered, the Commission has improved the COT reports in several other ways over the years. The Commission changed the publication schedule several times to provide information to the public more frequently – switching publication from monthly to twice monthly (mid-month and month-end) in 1990, to every two weeks in 1992, and to weekly in 2000. The Commission has also acted to improve the timeliness of the reports – moving publication to the sixth business day after the "as of" date in 1990, and then to the third business day after the "as of" date in 1992. The Commission has also expanded the scope of the information included in the reports – adding data on the numbers of traders in each category, a crop-year breakout and concentration ratios in the early 1970s, and adding data on option positions in 1992. Finally, the Commission has made the COT reports more widely available – moving from a paid subscription-based mailing list to fee-based electronic access in 1993 and, since 1995, making the COT data freely available on the Commission's internet website.

[77] The COT reports are the most frequently visited section of the Commission's website. During FY 2008, to date, the COT reports received over 1.3 million visits.

Appendix E

History of Speculative Position Limits

In June of 1936, the Commodity Exchange Act was enacted, extending Federal regulation to a list of enumerated commodities that included, among other things, cotton, rice, butter, eggs and potatoes in addition to the grains. In December 1938, the Commodity Exchange Commission[78] promulgated the first Federal speculative position limits for futures contracts in the grains (then defined as wheat, corn, oats, barley, flaxseed, grain sorghums and rye), but did not impose limits in the other commodities enumerated in the 1936 Act.[79] Over the following years, Federal limits were extended to various other commodities enumerated in the Act. In some cases, Federal limits were applied to commodities already listed in the original 1936 Act.[80] In other cases, Federal limits were applied to new commodities added to the list of enumerated commodities by subsequent amendments to the Act.[81] However, no uniform rule regarding speculative position limits was applied to the commodities enumerated in the Act. In some cases (*e.g.*, soybeans), a commodity added to the Act's list of enumerated commodities was also added to the roster of commodities subject to Federal speculative position limits. In other cases (*e.g.*, grain sorghums), commodities enumerated in the Act never became subject to Federal position limits. Frequently, such commodities were omitted from the Federal position limit rules in apparent deference to the fact that they were already subject to speculative position limits imposed by the exchanges where they were traded. For example, after livestock products were added to the list of enumerated commodities by the 1968 amendments to the Act, the Commodity Exchange Authority never imposed Federal speculative position limits on livestock products. Such products had already been subject to speculative position limits under the rules of the CME when they were brought under Federal regulation.

When the Commission opened its doors in April 1975, "various contract markets [had] voluntarily placed speculative position limits on 23 contracts involving 17 commodities."[82] At that time, "position limits were in effect for almost all actively traded commodities then under regulation, and the limits for positions in about one half of these actively traded commodities had been specified by the contract markets."[83] Initially, the Commission retained the position limits

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[78] The Commodity Exchange Commission is the predecessor of the Commodity Exchange Authority, which is in turn, the predecessor of the Commission.

[79] 3 FR 3145 (December 24, 1938).

[80] For example, speculative limits were imposed on cotton in 1940. *See* 5 FR 3198 (August 28, 1940).

[81] For example, the Act was amended: in 1940 to add fats and oils (including soybean oil), soybeans and soybean meal; in 1954 to add wool; in 1955 to add onions; and in 1968 to add, among other things, livestock products (e.g., live cattle, live hogs, pork bellies) and frozen concentrated orange juice.

[82] 45 FR 79831 (December 2, 1980).

[83] *Id.* at 79832. "Commodity Exchange Authority regulations included limits for wheat, corn, oats, soybeans, cotton, eggs and potatoes. Exchange rules included limits for live cattle, feeder cattle, live hogs, frozen pork bellies, soybean oil, soybean meal, and grain sorghums." (*Id.*, note1)

enacted by the Commodity Exchange Authority, as then in effect, but did not establish position limits for any additional commodities.[84] In the years immediately following, the Commission implemented a few relatively minor changes to the position limits regulations, but undertook no significant expansion of speculative position limits.

In fact, serious questions were raised concerning the effectiveness of position limits as a regulatory tool. The newly created Commission had appointed a number of advisory committees to advise it on issues relating to its new regulatory role. One of these, the Advisory Committee on the Economic Role of Contract Markets, reviewed the subject of speculative position limits. The Advisory Committee found speculative position limits to be of limited utility, noting that, "these limits provide little control over the activities of large hedgers, and virtually no control during the crucial delivery months."[85] The Advisory Committee recommended that "Speculative position limits should not play a major role in the CFTC's future regulatory program. In the long run, they should be supplanted by an improved monitoring and surveillance program designed to achieve orderly liquidation of expiring contract months."[86]

A 1977 analysis by the Commission's Office of the Chief Economist (OCE) also considered basic issues regarding speculative position limits, including: "(1) whether there should be limits and for what groups of commodities, (2) what limits should be imposed, and (3) whether the Commission or the exchanges should set the limits."[87] The staff analysis found that factors such as breadth of supply, storability, and fungibility of a commodity, along with low transportation costs, ease of delivery and liquidity in the cash and futures markets "tend to promote (but do not guarantee) arbitrage between the cash and futures markets" and that such arbitrage, "if it exists, to any appreciable degree, causes the cash and futures markets to be highly interrelated," which limits the potential for a large futures position to influence the price level.[88]

Nevertheless, the staff analysis found that, "Other things held equal, sufficiently large positions and trades can become a perceptible market factor," and recommended that position limits should be set in some, but not all, markets:

> The Commission [should] adopt a policy of establishing speculative limits in those markets where the characteristics of the commodity, its marketing system, and the contract lend themselves to undue influence from large scale speculative positions.[89]

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[84] Pursuant to section 4l of the Commodity Futures Trading Commission Act of 1974, 88 Stat. 1414, all regulations previously adopted by the Commodity Exchange Authority continued in full force and effect, to the extent they were not inconsistent with the Commodity Exchange Act, as amended, unless or until terminated, modified or suspended by the Commission.

[85] *Report of the Commodity Futures Trading Commission Advisory Committee on the Economic Role of Contract Markets*, at 7 (July 17, 1976).

[86] *Id.*

[87] *Speculative Limits*, a staff paper by the Commission's Office of the Chief Economist, cited at 45 FR 79831, at 79832 (December 2, 1980).

[88] *Id.*

[89] *Id.*

The staff study also recommended that "where limits are necessary, the exchanges should set and review the limits subject to Commission approval," noting that "the exchanges have the necessary competence and knowledge of the particular commodity to establish the limits."[90]

Subsequently, though, events in the silver futures market during late 1979 to early 1980, commonly referred to as "the Hunt Brothers silver manipulation,"[91] caused the Commission to conclude that "The recent events in silver … suggest that the capacity of any futures market to absorb large positions in an orderly manner is not unlimited."[92] Accordingly, the Commission adopted Regulation 1.61, which required all DCMs to adopt and submit for Commission approval speculative position limits in active futures markets for which no exchange or Commission limits were then in effect.[93]

The next significant development regarding speculative position limits occurred in 1986, when the Commission undertook a comprehensive review of speculative position limit policies, including position limit levels. Congress, during the Commission's 1986 reauthorization, had suggested that this subject should be addressed. As noted in the Report of the House Agriculture Committee:

> … the Committee believes that, given the changes in the nature of these markets and the influx of new market participants over the last decade, the Commission should reexamine the current levels of speculative position limits with a view toward elimination of unnecessary impediments to expanded market use.[94]

Consistent with Congressional intent, the Commission in October 1987 adopted final rule amendments revising the structure of the position limit regulations and raising some of the limits.[95] The major changes introduced in the Federal speculative position limits in 1987 included: (1) the Commission retained the current spot month and individual month limits, but increased the all-months-combined levels; (2) the Commission revised the limits, which had historically been set on a generic commodity basis, to establish levels for each contract market "according to the individual characteristics of that contract market;"[96] and (3) in response to a petition by the Chicago Board of Trade, soybean oil and soybean meal, which had been subject to exchange limits, were made subject to Federal limits, "providing consistency with all other agricultural commodities traded at the CBOT."[97]

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[90] *Id.*

[91] *See*: In re: Nelson Bunker Hunt et al., CFTC Docket No. 85-12.

[92] 45 FR 79831, at 79833 (December 2, 1980).

[93] 46 FR 50938 (October 16, 1981).

[94] H.R. Rep. No. 99-624, at 4 (1986).

[95] 52 FR 38914 (October 20, 1987).

[96] *Id.* at 38917.

[97] Petition for rulemaking of the Chicago Board of Trade, dated July 24, 1986, cited at 52 FR 6814 (March 5, 1987).

In 1992, the Commission adopted final rules adhering to the principle that speculative position limit levels should be increased based upon increases in the size of a contract's open interest (in addition to the traditional standard of distribution of speculative traders in the market). The formula was thereafter "routinely applied … as a matter of administrative practice when reviewing proposed exchange speculative position limits under Commission rule 1.61."[98]

During this same time frame, the Commission began a process that led to the adoption of position accountability rules for the (non-enumerated) contracts subject to exchange-set speculative position limits. Regulation 1.61, adopted in 1981, required exchanges to adopt speculative position limits for futures and option contracts not subject to Commission limits. Beginning in 1991, the Commission approved several exchange rules establishing position accountability in lieu of numerical position limits for certain contracts exhibiting significant trading volume and open interest, a highly liquid underlying cash market and ready arbitrage between the cash and futures markets.[99]

In 1999, the Commission simplified and reorganized its speculative position limit rules to include requirements for both Commission-set limits and the regulation 1.61 exchange-set limits in a single regulation, Part 150. Regulation 150.5(e), establishes a "Trader accountability exemption."[100] This provision codifies the position accountability rules that began as an administrative practice in 1991. It provides that, for futures and option contracts that have been listed for trading for at least 12 months, an exchange may submit a position accountability rule, in lieu of a numerical limit, as follows:

1. For contracts on a financial instrument or product having average month-end open interest of 50,000 contracts and average daily trading volume of 100,000 contracts and a very highly liquid cash market, an exchange may submit a rule requiring traders to provide information about their position on request;

2. For contracts on a financial instrument or product or on an intangible commodity having average month-end open interest of 50,000 contracts and average daily volume of 25,000 contracts and a highly liquid cash market, an exchange may submit a rule requiring traders to provide information about their position on request and to consent to halt increasing the trader's position if so ordered by the exchange; and

3. For contracts on a tangible commodity, "including but not limited to metals, energy products, or international soft agricultural products [coffee, sugar, cocoa]," having average month-end open interest of 50,000 contracts and average daily volume of 5,000 contracts and a liquid cash market, an exchange may submit a rule requiring traders to provide information about their position on request and to consent to halt increasing the

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[98] 63 FR 38525 (July 17, 1998).

[99] *See*, for example, notices of proposed exchange rule changes published at 56 FR 51687 (October 15, 1991) and 57 FR 29064 (June 30, 1992).

[100] 64 FR 24038, at 24048 (May 5, 1999).

> trader's position if so ordered by the exchange, *provided that* for such tangible commodities, exchanges are not exempt from the requirement to set numerical spot month limits at a level no greater than one quarter of the estimated spot month deliverable supply.[101]

The reorganized rules also included new regulation 150.5, which codified the Commission's 1992 formula for calculating Federal speculative position limits based upon open interest, and applied it to exchanges for their use in calculating the levels of exchange-imposed numerical speculative position limits. The formula provided for "combined futures and option speculative position limits for both a single month and for all-months-combined at the level of 10 percent of open interest up to an open interest of 25,000 contracts, with a marginal increase of 2.5 percent thereafter."[102]

As noted above, in 2000 the CFMA was enacted, including Core Principle 5 requiring DCMs to implement position limits or position accountability for speculators "where necessary and appropriate." The Commission's Acceptable Practices for complying with Core Principle 5, set out in Appendix B to part 38 of the Commissions regulations,[103] specifically reference part 150 of the Commission's regulations as providing guidance on how to comply with Core Principle 5. The CFMA did not change the treatment of the enumerated agricultural commodities, which remain subject to Federal speculative position limits. In 2005, the Commission increased single month and all-months-combined Federal speculative position limits, based generally upon the 1992 formula (as incorporated into regulation 150.5).[104] As in previous position limit rulemakings, the spot month limits were not increased. In 2007, the Commission proposed further non-spot month increases in Federal speculative position limits, based upon the regulation 150.5 open interest formula.[105] After reviewing comments on the proposed rules, the Commission determined to "withdraw the proposed rulemaking pending further consideration of the relevant issues."[106]

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[101] The Commission's concern regarding spot month limits was mirrored by the CFMA, which provides in DCM Core Principle 5 (section 5(d)(5) of the Act), that "To reduce the potential threat of market manipulation or congestion, **especially during trading in the delivery month**, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate." [emphasis supplied]

[102] 64 FR 24038, at 25039.

[103] 17 CFR Part 38, Appendix B, Core Principle 5(b)(2).

[104] 70 FR 24705 (May 11, 2005).

[105] 72 FR 65483 (November 21, 2007).

[106] 73 FR 32261 (June 6, 2008).

Appendix F

Special Call Letter to Commodity Swaps Dealers

I. Commodity Index Transactions

A. Provide the total notional value (in U.S. dollar equivalents) of all outstanding commodity index transactions, showing the gross long and gross short notional value.[107] Separately show how much of that total notional value is referenced to U.S. futures markets versus non-U.S. futures markets.

B. For the total notional value reported in I.A, provide the notional value by "brand" of commodity index, e.g., S&P GSCI, DJ-AIG, including any sub-indices or variants. If the transaction involves returns on a non-standard index, indicate "Other Index." (Use your best judgment on whether a specific basket of index commodities is a subset/variant of a standard index or whether it is different enough to be classified as "Other.") For each of these index groups, list every U.S. futures market included, showing the long and short notional value. (Show the notional value in WTI crude oil as NYMEX, even if some part of the position is actually traded on the ICE Futures-Europe WTI contract. Show separately notional values for wheat in the CBOT, MGEX, and KCBT markets.) [see Attachment 1 for a sample format]

II. Futures Equivalent Positions and Types of Clients/Counterparties [see Attachment 2 for a sample format]

A. Futures Equivalent Positions.[108] Provide the futures equivalent positions by U.S. commodity futures market, separately for long and short positions, resulting from:

1. Commodity index transactions, for each commodity identified in 1.B.

2. Any bilateral, non-cleared commodity swap or other derivative transaction in a single physical commodity that either references a U.S. futures market price or is hedged in a U.S. futures market. Swaps on emissions and weather need not be included, nor swaps on financial products. Forward contracts for actual delivery or receipt of a commodity are excluded. If within the entity responding to this call, you have a unit that owns physical

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[107] Positions should be shown from the perspective of your client or counterparty, e.g., if your client is the fixed-price payer, that position should be shown as a long position. In other words, "long" notional value is that which, if you hedged it, would result in long futures positions, and "short" notional value is that which would result in short futures positions.

[108] "Futures equivalent positions" shall included futures and delta-adjusted options and should be provided based upon all outstanding OTC transactions regardless of whether the transaction resulted in an open futures position on the exchange, i.e., it should include an estimate of positions that have been offset internally and have not resulted in trading in the futures market.

assets (inventory, production, exports,...) and the swap is a hedge against that specific physical activity, then you should exclude that swap. In other words, in this section of the call, show your activity as a swaps dealer, not as an enterprise in a physical market.

B. Types of Clients/Counterparties.[109] For positions identified in II.A.1, provide a breakout by type of client: index funds, institutional investors, sovereign wealth funds, and "other."[110] For positions identified in II.A.2, provide a breakout showing aggregate non-commercial, commercial, and intermediary counterparty[111] positions, long and short. Where you do know the ultimate client's identify, regardless of whether they are trading through an intermediary, please classify as noncommercial or commercial based upon the preponderance of that client's business activity.

III. Client/Counterparty Identity

Provide the identity of each client/counterparty in II.A whose total notional value with you represents a futures equivalent position (as defined in footnote 2) equal to or greater than 25 percent of the Federal or exchange single-month position limit or position accountability level for any U.S. commodity futures market. In addition to their identity, show their futures equivalent positions in those markets where their position is at or above the 25 percent threshold level just described, and indicate in which of the categories in II.B they appear. For purposes of determining a client/counterparty, sum up all the business you do with the client and entities under common ownership (10 percent or greater financial interest) or control, as best you know. The 25 percent threshold should then be applied as follows: add up all of the client's futures equivalent exposure gross long and short across all expiration months in a market, and then compare each of the gross long and gross short in that market to 25 percent of that market's single-month position limit or accountability rule. For example, in NYMEX WTI crude oil, the single-month accountability level is 10,000 contracts net long or short and 25 percent of that is 2,500 contracts. If you have a client that has business with you that is equivalent to 1,000 long in the August future, 1,500 short in the September future, and 2,000 long in the October future, then their gross exposure (3,000 long and 1,500 short) meets the reporting criteria of 2,500 contracts.

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[109] For the purposes of this report, a client or counterparty is the real owner/controller of the position. If a bank or other intermediary is simply facilitating the transaction, look through the intermediary to the client, where known.

[110] For the purposes of this report, an "index fund" shall mean a client/counterparty with a fiduciary obligation to match or track the results of a commodity index, including ETFs and ETNs based upon a commodity index; an "institutional investor" shall include pension funds, endowment funds, and other similar investors; and a "sovereign wealth fund" shall mean a non-U.S. government entity, including, for example, a government investment company or a government-run pension fund.

[111] For the purposes of this report, a "commercial" shall mean a client/counterparty who has market risk arising from physical market activities in the subject commodity, and the swap agreement is part of a risk-management strategy; the "intermediaries" category should include clients/counterparties that are intermediaries (other swaps dealers, banks, etc.) for whom you have no information on whether they are acting on behalf of noncommercial or commercial clients.. All other counterparties should be shown as "non-commercial."

If a client is 'reportable,' show the breakout of their futures equivalent position by expiration month.

In general, please feel free to submit, along with your response, descriptive materials about the nature of your business and the manner in which you answered the questions in the special call.

Special Call Letter to Commodity Index Traders

I. Commodity Index Transactions

A. Provide the total notional value of all outstanding commodity index investment, showing the gross long and short notional value. Separately show how much of that total notional value involves U.S. futures markets versus non-U.S. futures markets.

B. For the total notional value reported in I.A, provide the notional value by "brand" of commodity index, e.g., S&P GSCI, DJ-AIG, including any sub-indices or variants. If the transaction involves a non-standard index, indicate "Other Index." For each of these index groups, list every U.S. futures market included, showing the long and short notional value. (see Attachment 1 for a sample format)

II. Futures Equivalent Positions[112]

Provide the futures equivalent positions by U.S. commodity futures market, separately for long and short positions, resulting from commodity index trading identified in I.A. Show separately:

1. Commodity positions held directly in futures.

2. Commodity positions held through OTC commodity swap or other derivative transactions in an index or a single physical commodity. (see Attachment 2 for a sample format)

III. Client Identity

Provide, if known, a breakout of the total notional value by type of client: institutional investors, sovereign wealth funds, and "other."[113] Separately identify proprietary accounts (in aggregate) and each of your clients, if their total notional value with you is equal to or greater than $100 million. In addition to their identity, show their total notional value, and indicate in which of the categories (institutional investors, sovereign wealth funds, etc.) they appear.

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[112] "Futures equivalent positions" shall included futures and delta-adjusted options and should be provided based upon all outstanding notional value regardless of whether the notional value resulted in an open futures position on the exchange, i.e., it should include an estimate of positions that have been offset internally and have not resulted in trading in the futures market.

[113] For the purposes of this report, an "institutional investor" shall include pension funds, endowment funds, and other similar investors; and a "sovereign wealth fund" shall mean a non-U.S. government entity, including, for example, a government investment company or a government-run pension fund.

Appendix G

Commissioner Bart Chilton

Dissent

from

CFTC Recommendations in Connection with the Special Call Survey of Swaps Dealers
September 11, 2008

I respectfully dissent from the Commission's issuance of recommendations relating to the staff's special call survey of swaps dealers.

At the outset, let me state that my action does not represent any dissatisfaction or uncertainty regarding the efforts of agency staff. As I have noted previously, the staff of the Commission are highly dedicated, competent professionals, and I have the utmost confidence in their ability to carry out the mission of the agency as mandated by Congress, to ensure that America's futures markets perform their risk management and price discovery functions in a fair and efficient manner.

That said, I dissent from the issuance of the Commission's recommendations. I do not believe the Commission's recommendations go far enough, and I have significant concerns relating to the underlying analysis on which the recommendations are based. Specifically, I express doubts regarding the amount and type of data received in connection with the special call survey, the nature of the analysis, and I have a fundamental disagreement with certain conclusions underlying the Commission's recommendations.

I am concerned that, while I believe the staff did a tremendous amount of work in a short period of time, the agency may not have received the type of comprehensive data sets needed to make reliable analyses and conclusions. It is my understanding that staff have been in the process of receiving data within just the last few weeks, making an extremely short turn-around time for processing and analyzing this exceedingly complex issue. Most importantly, I regret that, certain conclusions may underlie these recommendations regarding the causality link between index traders and price movements, particularly in the crude oil market, and that these conclusions that do not appear necessarily to be ineluctably linked to the data received. Absent compelling evidence, I believe that the most responsible course of action is to refrain from making conclusions or declarative statements based upon such limited and unreliable data.

There is ample evidence that many have reached judgments regarding a positive causality link with regard to speculative trading and commodity pricing. For example, a report released last week by the United Nations Conference on Trade and Development states that, "although there is no conclusive evidence of the extent to which speculation is contributing to rising

commodity prices so far, there can be little doubt that it has significantly amplified price movements originally caused by changes in market fundamentals. "Commodity Prices, Capital Flows, and the Financing of Investment," Trade and Development Report 2008, September 2008, at 22. Similarly, in May 2008, the International Monetary Fund released a report stating, "[i]n summary, it appears that speculation has played a significant role in the run-up in oil prices as the U.S. dollar has weakened and investors have looked for a hedge in oil futures . . . ." Regional Economic Outlook, Middle East and Central Asia, International Monetary Fund World Economic and Financial Survey, May 2008, at 27. Indeed, even former Federal Reserve Board Chairman Alan Greenspan has noted, "Financial speculation did play a significant part in the rapid increase in oil prices." Financial Times, August 11, 2008. Similar conclusions about the effect of financial speculators in the commodities markets have been reached by others.* In sum, smart people can disagree on this issue. Accordingly, until we have a comprehensive, unbiased study of this issue, we should not be making declarative judgments as to causation or effect.

That being said, due to the critical nature of this issue, I believe the American public can no longer wait for studies or task forces. Given the data that we have received, I believe there are some appropriate conclusions that can be drawn, and certain recommendations that should be made. I believe, first and foremost, there is a great deal of information regarding the over-the-counter market that the agency does not routinely receive and that such information may be imprecise. This data may have a significant impact on the exchange-traded markets. Secondly, in my opinion it would also appear that such over-the-counter activity may, at times, have uneconomic effects on prices. Accordingly, I urge the Commission to make the following specific recommendations, based on the data that has been received up to this point:

- request that Congress provide specific statutory authorities to allow the Commission to obtain data regarding over-the-counter transactions that may impact exchange-traded markets;
- request that Congress provide specific statutory authorities to allow the Commission to address market disturbances or violations of the Commodity Exchange Act, based on the data received pursuant regarding over-the-counter transactions;
- request that Congress provide immediate authorization and appropriations for at least 100 additional FTEs to carry out these new responsibilities.

I agree is it desirable for the Commission to do all it can, using the full force and effect of its administrative authority, to address issues that may be having a deleterious effect on the pricing or risk management functions of the U.S. futures markets. At a minimum, these administrative actions could include:

- immediate cessation of issuance by staff, rather than review and analysis by the full Commission, of all hedge exemption requests;
- re-analysis of the practice of issuance of non-commercial hedge exemptions;
- issuance of regulations to ensure firewalls between research and trading functions of investment banks; and
- re-analysis of appropriate classifications of traders.

I recognize that several of these administrative initiatives are included, at least in part, in the Commission's recommendations; my dissent, however, is based on my concern that these regulatory responses are not the primary actions the Commission should be undertaking. Rather, we should be recommending that Congress provide the agency with the specific statutory authorities identified above. I believe the Commission's recommendations do not address the entirety of the concerns identified, and that they simply do not go far enough to ensure that commodity pricing in futures markets accurately reflects the forces of supply and demand.

Finally, I have several concerns relating to the issuance of these recommendations based on the staff survey of swaps dealers, and the upcoming release of a report by the Interagency Task Force on Commodity Markets (Interagency Task Force). The Interagency Task Force released an Interim Report on July 22nd that contained statements about speculative activity in the oil markets. Those statements were at best premature given that key information, such as the type of data on which the CFTC bases its instant recommendations, was not available for analysis by the Interagency Task Force. As noted, the reliability of the data and the conclusions of the staff's analysis cause concern that, should the Interagency Task Force Final Report rely on that analysis and review, its findings and conclusions will be similarly tainted.

Bart Chilton
Commissioner

* E.g., "The Oil Price Really Is A Speculative Bubble," R. S. Eckaus, Center for Energy and Environmental Policy Research, Joint Center of the Department of Economics, MIT Energy Initiative, and Sloan School of Management, June 2008 ("Since there is no reason based on current and expected supply and demand that justified the current price of oil, what is left? The oil price is a speculative bubble." At 8); "Seeking the Causes of the July 3rd Spike in World Oil Prices," Robert F. McCoullough, Jr., McCoullough Research, August 2008 ("There is a strong possibility that the high level of concentration in the spot and future oil markets have made the market strategies of the principal market participants more significant than fundamentals – at least in the short term." At 8); "Institutional investors are one of, if not the primary, factors affecting commodities prices today." Testimony of Michael Masters, Masters Capital Management, before the Committee on Homeland Security and Governmental Affairs, United States Senate, May 20, 2008.

GLOSSARY

Arbitrage: A strategy involving the simultaneous purchase and sale of identical or equivalent commodity futures contracts or other instruments across two or more markets in order to benefit from a discrepancy in their price relationship. In a theoretical efficient market, there is a lack of opportunity for profitable arbitrage. See **Spread**.

Basis: The difference between the spot or cash price of a commodity and the price of the nearest futures contract for the same or a related commodity. Basis is usually computed in relation to the futures contract next to expire and may reflect different time periods, product forms, grades, or locations.

Board of Trade: Any organized exchange or other trading facility for the trading of futures and/or option contracts.

Buyer: A market participant who takes a long futures position or buys an option. An option buyer is also called a taker, holder, or owner.

Cash Commodity: The physical or actual commodity as distinguished from the futures contract, sometimes called spot commodity or actuals.

Cash Market: The market for the cash commodity itself (as contrasted to a futures or other derivatives contract) taking the form of either an organized, self-regulated central market (*e.g.*, a commodity exchange) or a decentralized over-the-counter market. Trading in the cash market may be for spot (immediate) or deferred/forward delivery.

Cash Price: The price in the marketplace for actual cash or spot commodities to be delivered via customary marketing channels.

Cash Settlement: A method of settling certain futures or option contracts whereby the seller (or short) and buyer (or long) exchange a payment based on the cash value of the commodity traded according to a procedure specified in the contract in lieu if the seller making delivery of the underlying commodity. Also called Financial Settlement.

CFTC Form 40: The form used by large traders to report their futures and option positions and the purposes of those positions.

Clearing: The procedure through which the clearing organization becomes the buyer to each seller of a futures contract or other derivative, and the seller to each buyer for clearing members.

Clearing Member: A member of a clearing organization. All trades of a non-clearing member must be processed and eventually settled through a clearing member.

Clearing Organization or Clearing House: An entity through which futures and other derivative transactions are cleared and settled. It is also charged with assuring the proper conduct

of each contract's delivery procedures and the adequate financing of trading. A clearing organization may be a division of a particular exchange, an adjunct or affiliate thereof, or a freestanding entity.

Commitments of Traders Report (COT): A weekly report from the CFTC providing a breakdown of each Tuesday's open interest for markets in which 20 or more traders hold positions equal to or above the reporting levels established by the CFTC. Open interest is broken down by aggregate commercial, noncommercial, and non-reportable holdings. With respect to the COT report commercial traders include a trader involved in the production, processing, or merchandising of a commodity and swap dealers using the futures or options markets to offset risks they hold due to swap positions on their books. The COT reports also report the positions of noncommercial traders held as spread positions between delivery months.

Commodity Index: An index or average, which may be weighted, of selected commodity prices, intended to be representative of the markets in general or a specific subset of commodities, *e.g.*, energy products or grains.

Commodity Index Trading: A passive investment strategy that attempts to replicate the return on an index of commodities by holding futures positions in correspondence to their weight in a specified commodity index.

Commodity Swap: A swap in which the payout to at least one counterparty is based on the price of a commodity or the level of a commodity index.

Congestion: A market situation in which shorts attempting to cover their positions are unable to find an adequate supply of contracts provided by longs willing to liquidate or by new sellers willing to enter the market, except at sharply higher prices.

Contract Market: A board of trade or exchange approved by the Commodity Futures Trading Commission to trade futures or options under the Commodity Exchange Act. A contract market can allow both institutional and retail participants and can list for trading futures contracts on any commodity, provided that each contract is not readily susceptible to manipulation. Also called a **Designated Contract Market (DCM)**.

Contract/Delivery Month: The specified month within which a futures contract matures and can be settled by delivery or the specified month in which the delivery period begins.

Cross-Hedge: Hedging a cash market position in a futures or option contract for a different but price-related commodity.

Counterparty: The opposite party in a bilateral agreement, contract, or transaction, such as a swap. There are two counterparties to each trade.

Day Trader: A speculative trader who takes positions and then offsets them during the same trading session prior to the close of trading.

Deliverable Supply: That portion of the total supply of a commodity that meets the delivery specifications of a futures contract and that is available for delivery on the futures contract at its economic value.

Delivery: The tender and receipt of the actual commodity, the cash value of the commodity, or of a delivery instrument covering the commodity (e.g., warehouse receipts or shipping certificates), used to settle a futures contract.

Delivery Location: A location designated by a commodity exchange where stocks of a commodity represented by a futures contract may be delivered in fulfillment of the contract.

Derivative: A financial instrument, traded on or off an exchange, the price of which is directly dependent upon (*i.e.*, "derived from") the value of one or more underlying securities, equity indices, debt instruments, commodities, other derivative instruments, or any agreed upon pricing index or arrangement (*e.g.*, the movement over time of the Consumer Price Index or freight rates). Derivatives involve the trading of rights or obligations based on the underlying product, but do not directly transfer property. They are used to hedge risk or to exchange a floating rate of return for a fixed rate of return. Derivatives include futures, options, and swaps. For example, futures contracts are derivatives of the physical contract and options on futures are derivatives of futures contracts.

Designated Contract Market: See **Contract Market**.

Electronic Trading Facility: A trading facility that operates by an electronic or telecommunications network instead of a trading floor and maintains an automated audit trail of transactions.

Equivalent Futures Contracts or Position: The futures and delta-adjusted options on futures that would have been established on-exchange absent other internal offsets or nettings.

Exchange-Traded Fund (ETF): An investment vehicle holding an asset such as a commodity that issues shares that are traded like a stock on a securities exchange.

Exchange-Traded Futures Contract: An agreement to purchase or sell a commodity for delivery at a specified time in the future: (1) at a price (or pricing formula) that is determined at initiation of the contract; (2) that obligates each party to the contract to fulfill the contract at the specified price; (3) that is primarily used to assume or shift price risk without taking delivery of the underlying commodity; and (4) that may be satisfied by delivery, offset or cash settlement, as specified by the terms of the contract.

Exchange-Traded Note (ETN): A principal-protected investment vehicle the return on which is based on, for example, a commodity index rather than an interest rate.

Exempt Commercial Market: An electronic trading facility that trades exempt commodities on a principal-to-principal basis solely between persons that are eligible commercial entities.

Financial Settlement: See, **Cash settlement**.

Foreign Board of Trade: A futures exchange outside the United States.

Forward Contract: A commercial merchandising transaction common in many industries, including commodity merchandising, in which a commercial buyer and seller (with the capacity to make or take delivery) agree upon delivery of a specified quality and quantity of a commodity at a specified future date. Terms may be more "personalized" than is the case with standardized futures contracts (*i.e.*, delivery time and amount are as determined between seller and buyer). A price may be agreed upon in advance, or there may be agreement that the price will be determined at the time of delivery.

Futures Commission Merchant (FCM): Individuals, associations, partnerships, corporations, and trusts that solicit or accept orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any exchange and that accept payment from or extend credit to those whose orders are accepted.

Hedge Exemption: An exemption from speculative position limits for *bona fide* hedgers and certain other persons who meet the requirements of exchange or CFTC rules.

Hedger: A trader who enters into 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 who purchases or sells 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).

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).

Index Fund: A fund that has a fiduciary obligation to match or track the results of an index. As used in this report, a commodity index fund that tracks the performance of a commodity index.

Institutional Investor: A pension fund, endowment fund, and similar investors.

Large Traders: A large trader is one who holds or controls a position in any one future or in any one option expiration series of a commodity on any one exchange equaling or exceeding the exchange or CFTC-specified reporting level.

Liquidity: An aspect of a market indicating that selling and buying can be accomplished with minimal effect on price. The more liquid a market is, the easier it is to execute large trades with minimal price impact.

Long: (1) One who has bought a futures contract to establish a market position; (2) a market position that obligates the holder to take delivery; (3) one who owns an inventory of commodities.

Manipulation: Any planned operation, transaction, or practice that causes or maintains an artificial price. Specific types include corners and squeezes as well as unusually large purchases or sales of a commodity or security in a short period of time in order to distort prices, and putting out false information in order to distort prices.

Market Maker: In the futures industry, a trader who, in speculating for his own account, provides bids and offers for commercial users of the market.

Nearbys: The nearest delivery months of a commodity futures market.

Non-commercial: A trader other than a commercial, that is, a trader that is not involved in the production, processing, or merchandising or other commercial activity in the commodity it is trading.

Notional Value: In an interest rate swap, forward rate agreement, or other derivative instrument, the amount or, in a currency swap, each of the amounts to which interest rates are applied in order to calculate periodic payment obligations.

Offer: An indication of willingness to sell at a given price; opposite of bid, the price level of the offer may be referred to as the "ask."

Offset: Liquidating a purchase of futures contracts through the sale of an equal number of contracts of the same delivery month, or liquidating a short sale of futures through the purchase of an equal number of contracts of the same delivery month.

Open Interest: The total number of futures contracts long or short in a delivery month or market that has been entered into and not yet liquidated by an offsetting transaction or fulfilled by delivery.

Option: A contract that gives the buyer the right, but not the obligation, to buy (call) or sell (put) a specified quantity of a commodity or other instrument at a specific price within a specified period of time, regardless of the market price of that instrument.

Over-the-Counter (OTC) Market: The trading of commodities, contracts, or other instruments directly between two parties off of an exchange through an electronic network, facsimile or telephone. OTC trading may also be facilitated by market makers, or dealers, who make two-sided markets by offering to both buy and sell the commodities, contracts or other instruments.

Position: An interest in the market, either long or short, in the form of one or more open contracts.

Position Accountability: An enhanced market surveillance provision adopted, by rule, by an exchange. Under position accountability provisions, persons with positions exceeding exchange specific "accountability levels" are subject to increased oversight and the exchange has enhanced powers to address market problems. Persons exceeding the accountability level must report the nature of the position, trading strategy, and hedging information of the position to the exchange, upon request of the exchange. The exchange may take action to prohibit the person from increasing its position or may order that positions be reduced to address market problems.

Position Limit: See **Speculative Position Limit**.

Price Discovery: The process of determining the price level for a commodity based on supply and demand conditions. For organized exchanges, such as futures exchanges, the price discovery mechanism aggregates information and opinions on supply and demand fundamentals from multiple market participants to arrive at a price that reflects the collective judgment of those participants.

Reportable Level: The size of a futures position set by the exchange and/or the CFTC at or above which commodity traders or brokers who carry these accounts must make daily reports about the size of the position by commodity, by delivery month, and whether the position is controlled by a commercial or non-commercial trader.

Retail Investor/Customer: A customer that does not qualify as an eligible contract participant under Section 1a(12) of the Commodity Exchange Act, 7 USC 1a(12). An individual with total assets that do not exceed $10 million, or $5 million if the individual is entering into an agreement, contract, or transaction to manage risk, would be considered a retail customer.

Seller: A market participant who takes a short futures position or sells an option. An option seller is also called a grantor.

Short: (1) The selling side of an open futures contract; (2) a trader whose net position in the futures market shows an excess of open sales over open purchases.

Sovereign Wealth Fund (SWF): A non-U.S. government entity, including government investment companies and government-run pension funds.

Special Call: A request to a reportable (i.e. large) futures trader pursuant to CFTC Regulation 18.05 for further details regarding the trader's cash and derivative market positions.

Speculative Position Limit: The maximum position, either net long or net short, in one commodity future (or option) month or in all futures (or options) of one commodity combined that may be held or controlled by one person (other than a person granted a hedge exemption) as prescribed by an exchange and/or by the CFTC.

Speculator: In commodity futures, a trader who does not hedge, but who trades with the objective of achieving profits through the successful anticipation of outright price movements or through relative price movements in the case of spread trades.

Spot Market: Market of immediate delivery of and payment for the commodity. Contrasted with **Forward Contract.**

Spot Commodity: (1) The actual physical commodity (as distinguished from a futures contract); (2) sometimes used to refer to cash commodities available for immediate delivery.

Spot Month Contract: The futures contract that matures and becomes deliverable during the present month.

Spot Price: The price at which a physical commodity is bought and sold for immediate delivery at a given time and place.

Spread: The purchase of one futures delivery month against the sale of another futures delivery month of the same commodity; the purchase of one delivery month of one commodity against the sale of that same delivery month of a different commodity; or the purchase of one commodity in one market against the sale of the commodity in another market, to take advantage of a profit opportunity from a change in price relationships. The term spread is also used to refer to the difference between the price of a futures month and the price of another month of the same commodity. A spread can also apply to options.

Supplemental COT Report: A companion report to CFTC's regular weekly Commitments of Traders report that, for 12 agricultural markets, breaks out the amount of index trading.

Swap: In general, an OTC contract for the exchange of one asset or liability for a similar asset or liability for the purpose of lengthening or shortening maturities or otherwise shifting risks. See **Commodity Swap.**

Swap Dealer: An entity such as a bank or investment bank that markets swaps to end users. Swap dealers often manage the risk associated with their net swap positions by trading in the futures markets.

Underlying Commodity: The cash commodity or instrument underlying a futures or option contract.

Volume of Trading: The number of contracts traded during a specified period of time. It may be quoted as the number of contracts traded or as the total of physical units traded, such as bales or bushels, pounds or dozens.

Mr. ETHERIDGE. I thank the gentleman.

The chair would like to remind Members that they will be recognized for questions in order of seniority for Members who were here at the start of the hearing. After that, the Members will be recognized in order of their arrival. I appreciate the Members understanding of this. And with that, I recognize myself for 5 minutes.

As you know, a report was distributed yesterday which painted a slightly different view of index fund participation and commodity prices. The report by hedge fund manager Michael Masters claimed index funds had a notational value of $317 billion invested in commodities from July 2008, but your report claimed it to be $200 billion for June of 2008.

I seriously doubt that 1 month can account for the $117 billion difference between your figures and his figures. Your figure is based on information you received from market participants. Their figure is estimated by extrapolating from the CFTC's commodity index trading supplement to the Commitments of Traders report and mathematically applied to information publicly known about the composition of various indexes.

So I have a few questions. First, if $161 billion is tied to U.S. commodities I assume the rest is tied to foreign trade commodities; is that correct?

Mr. LUKKEN. Correct. In mostly the London Medal Exchange located in London.

Mr. ETHERIDGE. Now, how confident are you that your special call captured all or a significant amount of the data regarding index trading; *i.e.,* are there any avenues for index traders that your special call did not capture?

And, finally, assuming you disagree with the methodology of Mr. Masters' claim, what are the a flaws in his approach to give him such an inflated number?

Mr. LUKKEN. Well, our staff who have compiled this report feel comfortable that the net we cast for these index traders was brought up to capture virtually all activity in this area. Index trading, it is important to remember, has to be indexed off of a futures market, regulated futures markets, which we see that data. So we know the major participants that are also participating over-the-counter in these index markets. We are able to identify them, the 32 entities that we sent letters to, and we feel very confident that we captured all of that activity. I think staff is confident in that $200 billion number.

Mr. ETHERIDGE. I assume you are familiar enough, then, with H.R. 6604, the Commodity Markets Transparency and Accountability Act of 2008, that Chairman Peterson and I introduced in the House and was considered a little over a month ago. The bill, among other things, would have the Commission setting position limits, providing for greater transparency in the over-the-counter market and limiting hedge exemptions to those who can demonstrate a true need for the underlying physical commodity. Let us assume that bill became law today. What additional resources in terms of staffing and technology would be necessary to implement the new law and how much would all this cost in 2009 and 2010?

Mr. LUKKEN. We have asked our staff, our budget staff, to take a look at this. It is roughly $35 million to implement those provisions, which equates to about 160 FTE staff employees at the agency.

Mr. ETHERIDGE. And we will come back to that first question in just a minute, because I want to get all three of them in. I will let you answer them together. The Commission report covers January through June of 2008, just a 6 month slice; however, commodities have been rising, not as dramatically as they were since 2006, but they were rising. Does the Commission have over-the-counter data for prior to January of this year; *i.e.,* 2006 and 2005?

Mr. LUKKEN. Our compelled survey did not cover anything before December 31, 2007.

Mr. ETHERIDGE. But you can get that data?

Mr. LUKKEN. We could ask for it certainly.

Mr. ETHERIDGE. And my other question is, does it have data for July and August when commodity prices started to decline, and is there any plan or intention to look at these other periods? Let me tell you why I ask this question. Because if you look at this slice only, you really don't have a lot to work with. You need to go back before it started up, and when it went down, and then you can start finding out what was going on in the process. And I think that is very important, and I would hope the Commission would take a look at that.

And now I am going to let you go back. I hope the answer to that is yes. If not——

Mr. LUKKEN. Well, we certainly want to continue to look at the data going forward. Because we have been compiling and analyzing the June, March, and December data, we have not had an opportunity to look at July, August, and now we are into September. But it is certainly our intention to continue to follow these trends to see what is happening in these markets. We tried to, over that 6 month period of time, capture the largest run-up in commodities that we saw. Certainly there were record prices for most commodities during that period, the largest run-up in crude during that period. And I will be honest, given the sort of limited resources we had and the time constraints we were under, we had to choose which period to go after, and that seemed like a logical one to begin with to look at.

Mr. ETHERIDGE. Well, it seems to me if you don't go back, though, you don't have the numbers to know where it came from or how it got in. I assume you still want to answer the question dealing with your disagreement with Mr. Masters' report.

Mr. LUKKEN. Our data is a direct, compelled, survey under law that we sent out to all of these registrants, the people who are in our markets, asking them directly how much index money is occurring in the markets. I believe Mr. Masters has extrapolated using some of our public data that we put out, and then sort of reverse engineered. But in the course of doing so there are several major assumptions that have to be made and a potential for a large margin of error. But, again, this is the best data we have on index trading out there because it is directly coming from those who are participating in those markets.

Mr. ETHERIDGE. The gentleman from Virginia.

Mr. GOODLATTE. Thank you Mr. Chairman. Chairman Lukken, some have alleged that the important distinction between commodities futures and financial futures were lost to regulators. Would you care to comment on it?

Mr. LUKKEN. Well, in the futures markets people are not necessarily buying a barrel of oil in the futures markets; they are buying the change in price of a commodity. I know there are a lot of people who think that buying and selling in futures markets are similar to the stock markets where you are bidding on one commodity, but that is not the case. In the futures markets you are able to continue to write, both on the short side and long side of the market, a limitless amount of contracts as long as you can come to agreement on what you believe is the price.

That is a distinction. The futures markets have some mechanisms that link the two. And certainly the delivery process in the futures markets is how that occurs. But most of this under today's discussion, index money, never reaches the delivery month. It is moved out of forward months into future months before delivery ever occurs. I think that is important to point out for today's discussion.

Mr. GOODLATTE. Do you agree with others that say that speculative bubbles can't form so long as physical hedgers are the dominant group in the marketplace?

Mr. LUKKEN. I think commercial participants are extremely important in order for markets to function correctly. And we want to try to promote healthy participation among commercials as best we can. Everybody brings information to the markets, whether you are speculators or commercials. Commercials have very valuable information. But those that are speculators are bringing valuable information, as well. And if they are wrong, they are not going to be in business very long. So we want to make sure there is a healthy blend, but certainly commercial participation is imperative.

Mr. GOODLATTE. So how does that comport with the testimony that the CFTC's Agriculture Advisory Committee received about the problems of the delivery mechanisms in future ag futures contracts?

Mr. LUKKEN. Certainly we have seen problems with the Chicago Board of Trade wheat contract. We have held two public meetings to discuss that, one in the spring and one over the summer, under chairmanship of Commissioner Dunn, who runs our Agriculture Advisory Committee. From that, we tasked the Chicago Board of Trade to go out and try to make changes to their contract terms. And they have come back with recommendations that are currently under Commission review. And we will have to decide—over a 45 day period—whether to approve that or not. We are closely looking at that, trying to get additional input, through comments, on whether this goes far enough. But we look forward to reviewing that over the next 45 days.

Mr. GOODLATTE. Do you think that putting position limits on OTC or swap transactions would encourage more activity on the regulated exchanges?

Mr. LUKKEN. It is difficult to tell. I think it would encourage some transactions to come on-exchange, but it also equally could

force things either overseas or into the over-the-counter market overseas. So it is difficult to know.

And, most importantly, it would be very difficult to police as a regulatory agency. Right now everything comes through a clearinghouse, a very centralized facility, for us to oversee. The over-the-counter market is very vast, large and dispersed, and it would be very difficult to impose those position limits.

Mr. GOODLATTE. You testified about the net notional index value for several important commodities. These numbers differ from other independent reports which suggest that speculator demand for those commodities is much higher. How do you explain the dramatic difference between the CFTC numbers and the other independent reports?

Mr. LUKKEN. Well, again this is referring to the Masters' report that came out yesterday. Again, not knowing exactly his methodology—and our staff is looking at how he came to his figures—but there is a lot of margin of error in reverse-engineering these numbers.

Mr. GOODLATTE. In your discussion about types of index investors, you delineated between index funds and institutional investors. Can you describe the difference between the two categories and explain the investing strategy for each?

Mr. LUKKEN. Well, institutional investors are primarily pension funds and endowments. They are seeking long-term exposure to commodity assets. Index investors are themselves running an index fund. But they may not want to manage this directly themselves. And so they may go to another swap dealer in order to do that for them. And they have clients that would benefit from these index investments—so they are part of that category. It is mostly endowment and pensions that are the customers of these index investments.

Mr. GOODLATTE. Thank you, Mr. Chairman.

Mr. ETHERIDGE. I thank the gentleman. The gentlelady from Kansas, Mrs. Boyda, for 5 minutes.

Mrs. BOYDA. Thank you very much, Mr. Chairman, and thank you for coming back again. It is a complicated and dense subject, so we appreciate your adding some light to it.

My question is just basically—if you would comment—you have made some recommendations: Enhanced transparency, increased reporting and information, overall modernization of several rules. When we get that done, and I have ultimate faith that this body will actually get that done, I know some people are not believing that we will get it; but when we get that done, what kind of an impact would you say that that would have on prices right now?

And I am not asking you to get down to the dollar or cent or anything, but little impact, big impact, what do you think we are going to find out once we do it?

Mr. LUKKEN. As a regulator, it is difficult to project what might have an impact on prices. I think our role should be making sure the markets are working efficiently and reflecting supply and demand.

Mrs. BOYDA. Do you think it will have an impact on prices?

Mr. LUKKEN. Well, I think it could help. Transparency will help to provide for efficiency in the market. Transparency is healthy to

the marketplace, to the regulators, to all. I think the more we can do on that front, the more assurance we can have that prices are actually reflecting the supply and demand, will mean more confidence that that is exactly what is occurring.

I think this paradigm shift in prices over the last year has all of us scratching our heads, what is going on, this has not been seen. Certainly opening the drapes, opening the doors, and shedding light on all of this is going to be helpful. Like I said, it is difficult for me to project how this is going to affect prices, but certainly transparency helps.

Mrs. BOYDA. And I think, if for no other reason, it helps the American people have additional confidence, and that is certainly worth doing as well.

I have no further questions. I yield back. But thank you again for you and your staff's service.

Mr. ETHERIDGE. I thank the gentlelady. The gentleman from Oklahoma, Mr. Lucas.

Mr. LUCAS. Thank you Mr. Chairman.

Chairman Lukken, let us turn back to the wheat market again for just a moment. Recent attention back home has been focused on not just the fact of the high prices in the market, but on the spread between cash and futures and what we all commonly refer to—what is referred to as basis.

The basis has been at a historic weak level with cash prices well below the futures price. I think the cash price today is an unbelievable $1.90 under the futures market at the delivery point.

As you mentioned earlier, participants in the wheat futures market have been meeting and discussing steps to address these abnormal weak basis levels. In your opinion, have the steps that have been proposed so far, will they solve the problem; or do the markets need further reforms?

Mr. LUKKEN. Well, this is out for comment right now and we, as a policy, don't like to draw conclusions until we hear from all of the public on these issues. But certainly I think these are steps in the right direction. I am not certain whether there are enough steps in this area, but it is something we want to hear from all comers before we make a final decision.

But you are exactly right. This is extremely troubling to the industry, and to the regulator, in whether these additional fees and delivery points are going to be enough. I know the idea of forced load-out, forced delivery, is being kicked around. But that also has some downsides. And so we are open to listening to the debate and trying to make a decision over the next 45 days.

Mr. LUCAS. One last question along that line, Mr. Chairman. Any idea why the index investors were so interested in wheat? I think the stats I have seen is of the $19 billion in value in contracts, 47 percent of that was held by what would be referred to as index investors.

Mr. LUKKEN. As these index funds put a certain percentage in different commodities, oftentimes they may not take into account the size of the underlying market. So wheat is one you point out where it seems to be a bigger percentage than others.

When looking at the data, and what was happening for wheat over this period of time, there didn't seem to be a strong correla-

tion: Such as, index money was moving in, prices were moving up. There was actually some inverse correlation during that period of time. It is a limited data set, we will give you that. But we are still trying to figure out why people might be interested more in this area and whether there is any direct correlation between index money and prices.

Mr. LUCAS. Well, I appreciate that, Mr. Chairman. And clearly it has got the attention of the folks out in the countryside considering the gyrations that we have been through this year.

With that, Mr. Chairman, I would yield back.

Mr. ETHERIDGE. I thank the gentleman. I now recognize the gentleman from Wisconsin, Mr. Kagen.

Mr. KAGEN. Thank you, Mr. Chairman. I am very interested to hear if you have caught anybody else that might be cheating during the time that you have been doing this study.

Mr. LUKKEN. Cheating?

Mr. KAGEN. Manipulating the marketplace.

Mr. LUKKEN. We announced early this summer that we have a nationwide crude oil investigation. And the first announcement of a case we brought was, I believe, in July—or it may have been June, I forget—against Optiver hedge fund for trying to manipulate the crude oil markets. We continue our investigation. We have a dozen of other inquiries out there that we continue to pursue. And it is a very fruitful endeavor, I believe.

Mr. KAGEN. Do you have sufficient staff to carry out that duty?

Mr. LUKKEN. We would like more.

Mr. KAGEN. And do you have a number? One hundred thirty people is the number in your report.

Mr. LUKKEN. Well, that is just for the regulatory side. These are our litigators, our enforcement guys. And a significant amount of our staff is devoted to this nationwide crude oil investigation. But there are other areas, agricultural products, foreign currency, in fact, we have devoted a team to just that area recently. So we certainly could use extra bodies. I am not sure I could put a figure on it but it would be significant.

Mr. KAGEN. One of the areas of interest to me in your report has to do with the types of index investors, and particularly the nine percent being the sovereign wealth fund. Could you explain in some detail what that means to the marketplace?

Mr. LUKKEN. I think there was concern among the public and Congress of whether sovereign wealth funds, those funds that are controlled by governments, may be trying to artificially move around commodities, in particular oil. This is something we wanted to get a better handle on, how much sovereign wealth fund activity was occurring in the swap dealer markets. Again, nine percent, some will argue whether that is a lot or a little. But certainly as you looked at the type of regions involved, there weren't oil producing states that we saw in these markets in the nine percent. They were mostly European, North American, a couple Asian funds. It is illustrative in some ways. We are not sure how many definitive conclusions we can draw from the data, though.

Mr. KAGEN. So the rumor that is out there that the Iraqi Government was buying oil off the marketplace wasn't true; you don't see that happening?

Mr. LUKKEN. Our staff did not undercover that information.

Mr. KAGEN. Thank you very much. I yield back my time.

Mr. ETHERIDGE. I thank the gentleman. The gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you.

Welcome back, Chairman Lukken. You are getting to be a regular visitor here and you get frequent flier points. I don't want to put words in your mouth, but I want to recap what I heard you say and then give you an opportunity to respond. You went out and looked at this data set for about the first two quarters of this year; took additional data, went back and compared it to the data that you already collect on an ongoing basis. And what I heard you say is you found some activities by some of these outside the normal regulatory realm that maybe were trading some larger position limits than would have been allowed had they been in a regulated environment; is that correct?

Mr. LUKKEN. Yes. We tried to, and there was concern that swap dealers were providing a loophole that some people were putting on positions through swap dealers in order to avoid running up on limits on-exchange. And so, as I mentioned, there were 18 noncommercial participants, those people who have been subject to limits, that ran up against these—had they combined their on-exchange and off-exchange activity, they would have run up against these limits.

Having said that, it was a nonsignificant amount in excess. If people are looking for an excessive loophole here, it didn't seem to us to be excessive. However, 18 is 18, you know. The rules of the game should be the same. And so it depends on how you approach this. But it is something that we want to further consider, is whether in looking at granting exemptions to swap dealers, whether there should be some limits on this type of activity.

Mr. NEUGEBAUER. Did you get enough—in the sweep for that data did you get enough information on their trading activity to then go back and look at activity in the marketplace? Did you get any sense that there was any activity there that would lead you to believe that there was market manipulation going on?

Mr. LUKKEN. We haven't been able to conduct that analysis yet. That is something we are doing, though, to make sure that none of this activity was troubling from a market surveillance point of view, so that is something we are looking into. But it is not something definitively you can say causes us concern at this time.

Mr. NEUGEBAUER. So would that mean your final report—as I understand it, is this an interim report that you released now?

Mr. LUKKEN. It is hard for me to commit to doing something given our staff resources. You know our hope is, and my intention is, to try to do a follow-up on this at some point in the near future. But again, the 40 people that were dedicated to this job were also doing a full-time job of monitoring the markets and other things, and I am not sure they can continue on this pace indefinitely. But, yes, that is—our hope is to provide further analysis down the road.

Mr. NEUGEBAUER. In the recommendations from your initial analysis here, does that require any Congressional activity for you to carry those out, or are they within the scope of, do you feel, like the regulatory authority?

Mr. LUKKEN. I mentioned our special call. And typically in the past, special call means special. It doesn't mean routine. We have traditionally gone after data on a need-to-know basis. If we saw something abnormal in the markets, we have used our special call to get more information. But over time we have had to stretch and use this as a more routine collection device. I think we would benefit from having some codification of that if that is something Congress wants to do. I think that actually is something as part of the Peterson bill that came out of this Committee, so that would be helpful.

Mr. NEUGEBAUER. I know one of the things that you told us when you were here, either last time or the time before, was that you were corresponding or having communications with other markets and other exchanges, foreign exchanges I guess. Did you find them cooperative, and do they show a similar interest in making sure that there is integrity and transparency in the marketplace?

Mr. LUKKEN. They are very cooperative. I used to go to the International Organization of Securities Commissions. They are the international standard setting body for regulators around the world. And I have to admit, the CFTC was more of a tier two regulator during that period of time. Now we are sort of the life of the party. Everybody wants to know what is happening in the commodity markets.

Next week, I am going overseas to the Technical Committee of IOSCO where this is going to be agenda item number one: What should regulators be doing differently in regards to commodities; how can we coordinate our efforts; how can we share information better? I am looking forward to playing a leadership role in next week's discussions.

Mr. NEUGEBAUER. I heard you say one thing, and this is a final comment, and I was glad to hear you say that. And there is a misconception out there about what the role of the regulators are, whether it is the CFTC or SEC. It is to make sure that there is integrity and transparency in the market. It is not to cause prices to go up or prices to go down, or people not to lose money or people to make money. So when I see some people trying to approach this process, this is a way that we can make oil prices go down or this is a way we can make commodity prices go down—not everybody wants prices to necessarily go down. And so I appreciate the caution that you have taken in this of approaching it from what is the correct perspective. And that is just focusing on the integrity, the transparency of those markets.

At the same time, we recognize we do not dominate all of these markets, and there are other alternatives that people can go and look at and trade and make these same transactions in other places. And we would like for them to continue to do that in our markets. I think it makes our markets better, it makes them stronger. So I appreciate your efforts and look forward to—one last question.

Mr. ETHERIDGE. I thank the gentleman for his comment. His time has expired. The gentleman from Ohio, Mr. Space.

Mr. SPACE. Thank you, Mr. Chairman.

Thank you, Mr. Chairman, as well for joining us today. I want to focus my inquiry into the types of clients utilizing swap dealers

for over-the-counter commodity transactions. Your preliminary recommendations reference a recommendation, at least that is what it appears to me, to eliminate the hedge exemption for swap dealers and create new limited risk management exemptions.

And specifically I understand from your report that a significant percentage of those clients are institutional investors.

Mr. LUKKEN. Yes.

Mr. SPACE. What is the percentage?

Mr. LUKKEN. I think they were in the 30—I don't know.

Mr. SPACE. Forty-two percent, perhaps.

Mr. LUKKEN. You probably have it in front of you. I can find it. But it is 35 to 40 percent maybe.

Mr. SPACE. Now, you also reference in these recommendations that, first of all, either an obligation to report to the CFTC and the applicable self-regulatory organizations when certain noncommercial swap clients reach a certain position level; and/or a certification that none of the swap dealers, noncommercial swap clients, exceed specified position limits in related exchange traded commodities.

Do you have any recommendations; more specific than that? What is the extent at which current procedures—or, put better, what measures can be taken to ensure that the system serves its traditional price setting function with respect to those two issues.

Mr. LUKKEN. I think the concern with the swaps exemption has traditionally been that it could be allowing a great deal of noncommercial participation that could not have participated that they come directly to the market. That is one reason that we looked to see how many instances there were of people going over these limits.

I think, as a matter of fairness and consistency, we should—if we are going to place limits on the regulated exchange, on ECMs, on foreign boards of trade, and now looking at swap dealers and their linkage to the market, this is something we should consider seriously as an agency—of holding the swap dealers' clients to position limits; that had they gone directly to an exchange, they would not exceed a position limit.

I think equally as important is getting that information for our surveillance. If somebody is holding an enormous position off-exchange and they also have a position on-exchange, that is of significant interest to us in case they are trying to game one off the other.

I think we want to explore it, but based on this survey, we don't have a definitive recommendation beyond going down this path to look at it. But, it would be an effective way of trying to provide confidence that people aren't using the swap exemption as a loophole.

Mr. SPACE. So I guess you don't have definitive recommendations beyond addressing the need to address that problem.

Mr. LUKKEN. The problem of spec limits more broadly in the over-the-counter market?

Mr. SPACE. Right.

Mr. LUKKEN. Well, again, because we know swap dealers are coming to the market to lay off positions, because they are coming to us for hedge exemptions, there is that direct linkage to our market. A lot of the over-the-counter market never comes to the futures

markets to offset those positions, and it is much more dispersed. We were talking 32 entities that we covered *versus* hundreds, and more than that, in the over-the-counter markets. I think this was an effective step to try to address that nexus.

Mr. SPACE. Thank you. I yield back.

Mr. ETHERIDGE. I thank the gentleman. The gentleman from Texas, Mr. Conaway.

Mr. CONAWAY. Thank you Mr. Chairman.

Mr. Lukken, thank you for coming today. My recollection of your testimony the last time you were here was that you and your staff had found no evidence to support the idea that speculation was having undue influence on the price of crude oil. With that as a backdrop, how does your testimony today differ from that?

Mr. LUKKEN. Our economists, as well as the interim task force report on speculation that came out in July, did not find evidence, direct evidence, that speculators were systematically driving up prices. I don't think we have changed our position on that. We are still looking. The task force continues its work, and hopefully will come out with something in the coming weeks.

Certainly today, trying to look at index money in particular, there doesn't seem to be clear evidence looking at crude oil where positions were actually coming down in futures equivalent positions during the time of the crude oil's biggest price run-up. It doesn't seem that there is a correlation there between price and investment.

So again, this is, as the Chairman noted, a limited data set. But just on this snapshot, there doesn't appear to be strong evidence that speculation, and in particular this index money, is driving up prices.

Mr. CONAWAY. There is a recent story in the newspaper relative to a scheme that was reported that a particular trader—and that might be the wrong phrase—contributed mightily to the run-up in the price of oil, and then got on the other side of that and profited when it came down dramatically in July and August. Can you mechanically do that?

Mr. LUKKEN. Certainly that is what traders try to do; they try to guess trends.

Mr. CONAWAY. It is one thing to guess a trend; it is something else to be the trend.

Mr. LUKKEN. I haven't seen that story, but if the trader is causing the run-up and causing the run-down, that is of concern to us. And that is what we look for every day: Do you have a large enough position to drive up prices, to corner the market, to squeeze it to drive up prices? That is something our economists do every day.

Mr. CONAWAY. Help us understand just the mechanics of how that works. In other words, if you have a position that pushed the price up, how do you get out of that position and profit on the way down without losing profit on the way up? Mechanically how does a trader, or whoever it is doing that, make that work?

Mr. LUKKEN. Typically on the way up, they are buying long positions. And then when they think there is going to be a price break, they can start selling—buying short positions that would profit. And that will offset those long positions and they will then profit

on the way down. I am not a trader so I can't get into the extreme nuance of it, but that is in essence the mechanics.

Mr. CONAWAY. You had some reluctance to answering the Chairman's direct question about going back to periods before December 31, 2007 and doing the same kind of analysis. Is your reluctance because you just simply don't have the staff and the staff time to do that?

Mr. LUKKEN. It is staff and resources. And as you go farther and farther back in time, the businesses that keep records, the records become less and less reliable the farther you go back. If we went back to 2003 or 2004 when this started, we are not even sure that some of these firms would have maintained those records. So we are certain of the reliability of the records and the information from this 6 month period.

Mr. CONAWAY. Did you learn enough out of this study to set in place, in an ideal world with the right amount of staff and resources, a scheme that would keep you, like I say, as live a basis as you could going forward, monitoring the kind of stuff that you think based on what you found you need to monitor? Do these recommendations encompass all of the things you need to do to be able to be live?

Because I assume finding something that happened 12 months ago is not nearly as valuable as finding it happening yesterday or the day before. So have you got the resources you need to do to be able to be as current with all that data gathering as you could, need to be?

Mr. LUKKEN. The codification of some of these transparency provisions is helpful. But a lot of this is just modernization of technology, making sure we have the tools to follow all this information correctly and trying to sort of piece this stuff together.

Mr. CONAWAY. Is that your recommendation three, the Office of CFTC Data Collection?

Mr. LUKKEN. That is part of it. It is to make sure that we are spending the right amount of attention on getting this information in and classifying it properly and auditing it and verifying it.

Mr. CONAWAY. You are talking about people as well as the hardware and software that go along with the collection process.

Mr. LUKKEN. Yes, all of the above.

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

Mr. ETHERIDGE. I thank the gentleman. The gentlelady from New York, Mrs. Gillibrand.

Mrs. GILLIBRAND. Hi. Thank you for coming. Thank you, Mr. Chairman, for holding this hearing. I want to talk about some of your recommendations, and then I want to talk about the objections to your report that is in your appendix.

First, your final recommendation of review of swap dealer commodity research independence, your report states that questions have been raised as to whether swap dealer futures trading activities, are sufficiently independent of any related or published commodity market research. You are therefore going to instruct the staff to conduct a review of the independence of swap dealers futures trading activities from affiliated commodity research and report back to the Commission. What do you expect to find?

Mr. LUKKEN. Well, we have heard complaints, and rightly so, of concerns that swap dealers, the research arm of a swap dealer may come out and say, "We expect oil to go to $150 a barrel or $200 a barrel," and not knowing exactly what the independence between that research department and the trading arm might be.

Now, certain parts of Sarbanes-Oxley, for these publicly held companies, ensure independence in some of these areas. But this is a new area for the Commodity Exchange Act and we need to find out more information, whether disclosure of what their positions may be—would that be useful? But certainly, we are trying to ensure that there is strong independence between, and firewalls between, those two parts of the Wall Street institution, the research and the trading arm. That is something we are looking at, whether there is enough independence now or not, and then we will come back with recommendations, either administrative or legislative.

Mrs. GILLIBRAND. And when do you expect those recommendations to be ready?

Mr. LUKKEN. As quickly as we can. I think that is something we are in the midst of researching, but hopefully as soon as possible.

Mrs. GILLIBRAND. In your *Appendix G,* Commissioner Bart Chilton wrote a dissenting letter, and he cites to many experts saying that speculation did have a role in oil prices—particularly Alan Greenspan—financial speculation did play a significant part in the rapid increase in oil prices and other financial sources. And his recommendations are different than yours.

And I want to go through what he recommends and then get your thoughts on them, why you disagree with that recommendation, or why you think that is not the right approach.

His first recommendation is he wants to request that Congress provide specific statutory authority to allow the Commission to obtain data regarding over-the-counter transactions that may impact exchange-traded markets.

Mr. LUKKEN. Actually, we have a recommendation to continue routine reporting by swap dealers in our markets. So we, in a different way, have recommended something very similar. And as I have mentioned, this would benefit from legislative codification.

Mrs. GILLIBRAND. And the second recommendation is you request that Congress provide specific statutory authority to allow the Commission to address market disturbances or violations of the Commodity Exchange Act based on the data received pursuant—regarding over-the-counter transactions. Do you think that is a good recommendation?

Mr. LUKKEN. This was a very specific report to swap dealers. This recommendation seemed to go beyond the swap dealer report. I think trying to understand what a market disturbance might be is difficult and subject to interpretation. And personally I just had concerns about the broad context of going after the entirety of the over-the-counter market and policing that market.

Mrs. GILLIBRAND. And then a third recommendation, I think you will agree with. He wants to request that Congress provide immediate authorization appropriations for at least 100 additional FTEs to carry out these new responsibilities. Is that the amount of staffing increase that you would need to follow up with your research

to continue to do the kinds of transparency actions that you would like to do?

Mr. LUKKEN. I think 100 is the low figure. So I guess that it is at least 100. But that was before even these additional recommendations, so it is going to be north of that.

Mrs. GILLIBRAND. And the other complaint he makes in his letter, and I just want to get your thoughts on it, he said that he thought that the conclusions that underlie the recommendations regarding the causality link between index traders and price movement, particularly in crude oil, that they did not appear necessarily to be ineluctably linked to the data received. He thought there was, summarizing, that there was some insufficient time to do the kind of analysis and information gathering that would be required and that therefore the data was flawed.

Mr. LUKKEN. We did not make hard and fast conclusions. We tried to, as much as possible, just provide the facts of what they show, trying to let people draw their own conclusions. What the facts showed in regards to crude oil, that although notional value for crude oil and index investment was going up over that 6 month period of time, if you break that into future contract equivalents it is actually decreasing in position levels. So having said all that, we still are making eight recommendations on trying to improve transparency. We haven't drawn conclusions based on this data set. We actually think that there are some things we can learn better going forward.

Mrs. GILLIBRAND. Thank you.

Mr. ETHERIDGE. I thank the gentlelady. The gentleman from Kansas, Mr. Moran.

Mr. MORAN. Mr. Chairman, thank you very much.

Mr. Chairman, welcome back to our Committee. Much of what we are talking about today is based upon the study, the analysis of information that you gathered, what you have seen over a short period of time. Let me first ask about the reliability of that data. The information that you obtained under the special call, what compels those receiving those requests to answer it accurately and truthfully?

Mr. LUKKEN. Well, it is under penalty of law. They would be fined and we would go after these individuals, administratively, if they violated and falsely reported.

Mr. MORAN. So we ought to have to a reasonably high level of assurance that the conclusions that you and others are drawing from this information is based upon accurate, truthful information?

Mr. LUKKEN. It's compelled. I apologize for interrupting, but we had 100 percent compliance.

Mr. MORAN. Good. We had—I think the impetus for this Committee's work began really because of oil prices, and we were looking at petroleum and the futures market as it relates to petroleum. I think there was a number of Members of this Committee, including its leadership, who became interested in the agriculture commodity aspect of futures trading as we got involved in the issues.

Is there any conclusion—is the information that you garnered and the conclusions that you have drawn, are there any different conclusions for agricultural commodities *versus* the oil markets or is the information kind of all encompassing. Are they the same

kind of conclusions and results regardless of what the commodity is that is being traded?

Mr. LUKKEN. I think if you are looking for correlations, and that is probably the most important thing, we did not see correlations of prices across commodities during this period of time. In fact, in oil we saw an inverse correlation. But in other commodities it was correlated at times and not correlated at other times. So there didn't seem to be a constant trend of investment and prices tracking together. So I would say that was consistent across the commodities we studied.

Mr. MORAN. So regardless of what the commodity was, the conclusions, the evidence is the same.

Mr. LUKKEN. It seemed to us, yes.

Mr. MORAN. Which is no correlation or minimal correlation.

Mr. LUKKEN. This, again, is a very limited data set, but from what we've looked at, yes.

Mr. MORAN. The information you presented shows that contracts held by index funds actually decreased during the period when oil prices went from $96 a barrel to $140 a barrel; is that true?

Mr. LUKKEN. Correct.

Mr. MORAN. Given that data, is the obvious or realistic, reasonable conclusion that there is no correlation between the increased price and the activity in the market?

Mr. LUKKEN. Again, it is hard for us to make those definitive conclusions. There doesn't seem to be evidence based on the limited data set that that is the case. I would say, as the prices were going up extremely fast in oil, one explanation for why positions may have been coming down is these index funds have to rebalance their portfolios because they got too invested in one commodity *versus* another. And oil was going up faster than most commodities, although there were lots of price rises going on at this time, so it makes some sense that they may have been counterbalancing by selling in order to get the portfolios aligned. That is something we are trying to get more information about. But that has some basis for what we are seeing.

Mr. MORAN. Mr. Chairman, the CFTC recommendations that is included in your testimony, I really can only find one item in that list that requires Congressional action and that is the additional staff and funding. Is that a correct assessment and do you feel confident that, given the additional resources and, I suppose, the authorities granted in the farm bill, that you have sufficient tools at your disposal to oversee and regulate these markets?

Mr. LUKKEN. I think resources are priority number one for us. There are a lot of things we can do under the current authority to oversee these markets and to modernize our systems.

I would say recommendations one and two would benefit from codification. As I mentioned, we are having to stretch our legal authority to go after some of this over-the-counter activity. We can do it, but it would help to have Congress' blessing behind it.

Mr. MORAN. Should we do that codification before you complete what you, I guess reluctantly, are doing in an expanded study and analysis? Should we wait for additional—to get out of the short time frame, the snapshot picture, should we be waiting before we

codify, or is the information now sufficient that we ought to move forward legislatively?

Mr. LUKKEN. I don't think there is a requirement one way or another. I think we are going to continue to pursue this. It would certainly benefit knowing that Congress has given us this authority in clear fashion and that we should be doing this.

Mr. MORAN. Chairman Lukken, thank you very much for your testimony.

Mr. Chairman, thank you for the opportunity to question.

Mr. ETHERIDGE. I thank the gentleman.

The gentleman from Georgia, Mr. Marshall for 5 minutes.

Mr. MARSHALL. Thank you, Mr. Chairman.

It would have been very helpful to all of us—no surprise—that had we had this report before the hearing and had an opportunity to digest it—I am sure it is extremely complicated. We have been stuck in other matters and just from a few things you said just a minute ago, Mr. Lukken, I guess I have to conclude that the report and your analysis didn't really provide you with enough information. You don't have enough information based upon the analysis that you have done so far to be comfortable one way or another about all these different issues that are facing us that we are wrestling with; is that correct?

Mr. LUKKEN. I think that is correct, yes.

Mr. MARSHALL. You have on page 3 a chart which is lists total OTC and on-exchange commodity index investment activity. We have been asking for disaggregation in a lot of different ways. It probably would be helpful if you could break that down: on-exchange, off-exchange and an index fund presence. So the same kind of chart, but instead of lumping everything together break it down and give us that information, and you probably do have that information available to you.

Mr. LUKKEN. I think we certainly do have the information of index funds that are trading directly to manage this in the markets. Swap dealers——

Mr. MARSHALL. Can't tell where it is coming from.

Mr. LUKKEN. Well, it is over-the-counter, but they aggregate a bunch of things together before coming to the exchange to manage that risk. So a portion of that could be index trading, but it is difficult to tell because it is an amalgam of lots of single commodities, swap business as well as——

Mr. MARSHALL. It would be real helpful to us if you could take a stab at that. And I know it would be very difficult because you can't really tell where all of this is coming from or what is motivating a particular trader to organize trading on a lot of different—across an awful lot of different commodities, but it would be very helpful if you could. You know, the argument we have repeatedly heard is that it is index-fund-type positions, these passive long positions on-exchange, on the regulated markets that have been causing price problems. And so this graph doesn't help us as much as maybe the underlying information would be able to help us.

I guess I have to ask you. You have had a lot of time to wrestle with this. You have probably gone through multiple drafts. I have been inquiring for several weeks, when is this coming out? When's it coming out? And you have had lots of conversations with your

fellow Commissioners and with staff. What are going to be the eye poppers here as people with expertise read through this, as the press reads through this and starts asking questions of people with expertise? What are people going to be surprised by? What is going to be the headline or what is going to be the news so that we are not surprised?

Mr. LUKKEN. Well, looking at the notional value—I think it is significant; $200 billion is a significant amount. It is probably less than had been estimated by others in the public. Certainly those over limits, had they come on-exchange, there were 18 noncommercial participants we found.

Mr. MARSHALL. Do we know whether they were long or short?

Mr. LUKKEN. Yes, we do note that on the report. It is on both sides of the markets. But it wasn't excessive, but certainly they were over limits.

Mr. MARSHALL. There was a newspaper article that appeared in *The Post*. This is 3 or 4 weeks ago. I can't tell you who wrote it. I can't really remember many of the details. But it suggested that a company had been able to—maybe it was 11 percent. You know the article I am talking about right now?

Mr. LUKKEN. Yes.

Mr. MARSHALL. Were they long or short?

Mr. LUKKEN. They were short to market.

Mr. MARSHALL. If I recall correctly, *The Post* article was sort of suggesting that they were long, and that was part of the explanation—and their ability to get beyond their limits, plus being long is part of the explanation for higher prices; and yet you are saying, in fact, they were short.

Mr. LUKKEN. They were a short spread trader. This was part of our survey when we were collecting data from individuals. A trader we thought was a swap dealer was actually more of an investment fund. And so as soon as we found out that information we, the next available time, changed their classification in our public reporting. But, again, that figure—they were net short the market and they were also spread over many months in that 10 percent figure.

Mr. MARSHALL. During that period of time they must have lost an awful lot of money, basically. They were probably very unhappy campers. Because if I recall correctly things were going up.

Mr. LUKKEN. I think during that period of time, yes.

Mr. MARSHALL. Mr. Chairman, obviously, we are all going to need, our staff is going to need time to digest all of this. I guess we will have to have a second hearing, maybe, with Chairman Lukken. I don't know. We really can't question too much on a report that we have just gotten with testimony that we just received.

Thank you for chairing the hearing. I look forward to additional work on this subject.

Mr. LUKKEN. And we are certainly willing to come up privately and brief Members. It is a lot to digest, so we welcome the opportunity to come up and talk to Members privately.

Mr. ETHERIDGE. I thank the gentleman; and before we close, Mr. Chairman, let me follow up on what Mr. Marshall said.

There have been many press accounts about the Commission's re-classification of certain positions in the oil market from commercial to noncommercial, and he alluded to it a few minutes ago.

These reports claim that speculators now account for 81 percent of oil contracts traded on NYMEX. Can you tell us more about the reclassification? How much of the market did these positions represent? What is the nature of the business of the entity so reclassified? And was a need for re-classification due to the misrepresentation of activities by the entity or by a mistake made by the Commission?

Mr. LUKKEN. The classification system is for public reporting purposes. Internationally, we get a lot of information about different traders—much more detailed information that we receive every day, and we are able to track their activities. So whether you are classified as commercial or noncommercial doesn't mean we are not watching you or monitoring you as closely as any other trader. And certainly it does not mean that you can gain an exemption as a result of being a commercial or a noncommercial entity. Whether you get a hedge exemption or not is a separate question, and that is important to note.

But as I mentioned, swap dealers are currently classified as commercial. And we learned that this entity was more of an investor and acting more as a hedge fund and decided to reclassify that position. I think it was 10 or 11 percent of the crude oil market. As was noted by Congressman Marshall, they were short the market; and most of it was spread trading, meaning they were selling and buying at the same time over a long-term time horizon.

That is what occurred. I have instructed staff to try to figure out whether this was a problem of ours or this was miss-classified by mistake, whether it was intentional. And that is something we are looking into.

We are certainly, as part of the recommendations, creating a new office to try to elevate this to make sure that we are classifying things correctly; and we are auditing things on a periodic basis and that we are able to verify this independently. We are trying to take steps to make sure this doesn't happen in the future.

Mr. ETHERIDGE. That would be something this Committee would be very interested in, and I appreciate you at least letting the Chairman and Ranking Member know what your conclusion to this is.

The gentleman from Georgia for one additional question.

Mr. MARSHALL. Thank you, Mr. Chairman.

I don't know whether you covered this in your recommendations. I just haven't had an opportunity to look at them. We have talked a lot about it, and many people suggested that additional transparency would be quite helpful and that perhaps the market could make the appropriate adjustments. We wouldn't have to be worrying about what the motivation was underlying a particular position. We could conceivably say we are not troubled by the idea that people are taking long-term positions just to acquire commodity interests, as opposed to the traditional speculator who is trying to figure out price and things like that, if we had more transparency.

And I have heard folks say that your Commitments of Traders report is not all that helpful. I understand that it is accessed an awful lot, but it doesn't help a great deal, because it is very difficult to figure out what it really means as far as the underlying motivations of the traders are concerned.

And someone suggested that both OTC and on-exchange, those who were doing deals, should be required as part of the deal, the two parties, to characterize what this deal is and why it is being done—and that is just every transaction that is done—in some uniform fashion that can get dumped into an appropriate software program, controlled by you so that you are in a position—not perhaps even more regularly than weekly—to describe where everybody's positions are in all these different markets and what is motivating them.

That means that the individual would continue to have their private business kept confidential, whether they are OTC or they are on-exchange, but it would also mean that the market generally—if some program like that could be developed and it could be refined enough—that generally the market could see what the heck is going on and take appropriate adjustments and make appropriate adjustments.

Have you all been considering that? Are you working on that, improving on the Commission and considering what might be done where the over-the-counter market transactions are concerned?

Mr. LUKKEN. I think you point out that, especially as the businesses becomes larger and more complex, our Commitments of Traders classification of noncommercial *versus* commercial has become less precise. I think we see and have seen in this exercise that there are some commercial entities that do some speculative activity and noncommercials that may do some limited commercial activity.

I think what we have recommended in this report is: first, to try to come up with better classifications. It may be getting rid of noncommercial, commercial, but, at a minimum, let's break out swap dealer activities so we can see what is happening with this type of entity.

Second, we recommended what we termed a long form reporting. If you are a large enough trader in our markets, we will get more detailed information about your trading activity. I'm not sure we can track transaction to transaction, but certainly, we would try to figure out what percentage of your business is what and what is going on, so we can classify you appropriately.

You mentioned the over-the-counter markets. One of our recommendations as well is to do some routine type of report like we have done today of swap dealer activity. So, we at least get a window into the market on occasion to see what is happening, whether trends are changing. I think that would be useful for the transparency purposes.

Mr. MARSHALL. And that is pretty much the extent of what you are considering. You are not going beyond that.

Mr. LUKKEN. That is in the recommendations of the report.

Mr. MARSHALL. Thank you, Mr. Chairman.

Mr. ETHERIDGE. I thank the gentleman.

The gentleman from Kansas for closing remarks.

Mr. MORAN. Mr. Chairman, I just would thank you, particularly Mr. Peterson, for conducting this hearing and offer my condolences to Mr. Peterson and his family.

I appreciate the testimony today of the Chairman of the CFTC. I look forward to the opportunity to further analyze what we are

being told. I look forward to additional reports from the CFTC and encourage my colleagues to be supportive of additional funding and personnel for the Commission.

And again, Mr. Chairman, thank you very much for the opportunity to be with you here today.

Mr. ETHERIDGE. I thank the gentleman.

Chairman Lukken, let me just say, as you know, we have just gotten the report, haven't had a chance to read it. As we do that, just please know there may be additional questions coming to the Commission along with requests and, depending upon what we get, could very well at some point have another opportunity to come back to the Hill and spend some time together.

Under the rules of the Committee, the record of today's hearing will remain open for 10 days to receive additional material and supplemental written responses from the witness to any question posed by a Member to the panel.

This hearing of the Committee on Agriculture is adjourned.

[Whereupon, at 2:21 p.m., the Committee was adjourned.]

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